THE POLITICAL ECONOMY OF FOREIGN DIRECT INVESTMENT DURING INTERNAL ARMED CONFLICT

By

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Abstract

It is commonly assumed that armed conflict deters foreign direct investment (FDI) and encourages capital flight and portfolio substitution, yet recent evidence suggests that foreign investors are not uniformly risk-adverse with respect to investments in conflict zones. The willingness of foreign investors to put funds at risk in conflict zones runs counter to the conventional wisdom in the academic literature, which is based on the proposition that armed conflict is bad for business. The complex relationship between armed conflict and FDI presents a counterintuitive research puzzle for the fields of security studies and international political economy, both of which assume that armed conflict increases 'capital flight' as mobile foreign investors seek more stable returns elsewhere.

This thesis uses a multi-method approach that incorporates a large-*N* study based on descriptive statistics as well as a structured focused comparison of internal armed conflicts in Iraq (2003-2010) and Afghanistan (2003-2012) that followed US-led military campaigns in order to address the question: *Why do countries involved in internal armed conflict continue to attract FDI?* In contrast to many of the cases in the large-*N* study, the small-*n* comparative analysis focuses on two cases in which an external military campaign preceded the emergence of intra-state violence.

The investigation of FDI in the cases of Afghanistan and Iraq is significant because each country experienced a counterinsurgency against the external military intervention, which would be expected to further increase the risk premium for foreign investors. The thesis offers new analytical insights on the armed conflict-FDI relationship through investigating the reasons why foreign investors may decide to invest in countries affected by on-going armed conflict. The central argument presented in this thesis is that

the presence of an external military intervention (EMI) involving ‘boots on the ground’ sends a positive signal about improvements in a country’s investment climate, thereby altering how foreign investors assess the risks associated with investment in conflict zones.

To my parents

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LIST OF ABBREVIATIONS

ACLED	Armed Conflict Location Event Dataset
CNPC	China National Petroleum Corporation
COW	Correlates of War Project
DRC	Democratic Republic of Congo
EMI	External Military Intervention
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
HIDC	High-Income Developing Countries
IMF	International Monetary Fund
IMU	Islamic Movement of Uzbekistan
IO	International Organisation
ISAF	International Security Assistance Force
LDC	Less Developing Countries
LIDC	Low-Income Developing Countries
MFDI	Manufacturing Foreign Direct Investment
MIDC	Middle-Income Developing Countries
MIGA	Multilateral Investment Guarantee Agency
MNC	Multinational Corporations
MSS	China Metallurgical Group Corporation
NATO	North Atlantic Treaty Organisation
OPIC	Overseas Private Investment Corporation
OVL	ONGC Videsh Limited
PELC	Political and Economic Link Consulting
PNB	Punjab National Bank
PKK	Kurdistan Workers Party
PRI	Political Risk Insurance
PRIO	Peace Research Institution Oslo
UAE	United Arab Emirates
UCDP	Uppsala Conflict Data Programme
UK	United Kingdom
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
US	United States
WMD	Weapons of Mass Destruction

INTRODUCTION: THE DYNAMICS OF FOREIGN DIRECT INVESTMENT IN ARMED CONFLICTS

Since the end of the Cold War, the frequency of armed conflict has declined at the same time as the growth of globalisation has led to greater cross-border flows of trade and finance. Greater international capital flows have not only benefited developed and stable economies, but also countries which have historically been associated with political instability and armed conflict. Although the growth of globalisation has necessitated the need to find new markets and new destinations for foreign direct investment (FDI), and the decline in armed conflicts over the past 50 years has facilitated its expansion, political instability and armed conflict continues to serve as a major deterrence for foreign investors accessing new markets.

The existing literature in security studies and international political economy scholarship suggests that foreign investors do not like political instability and armed conflict (see Woodward and Rolfe 1993, Schneider and Rey 1985, and Li 2006) as foreign investors are unwilling to accept the higher risk premium associated with investments in conflict zones (see Asiedu 2002, and Pierpont and Krueger 2005). This stems from the increase in the commercial and non-commercial risks of doing business in a politically unstable environment which leads to potential investors avoiding armed conflicts, whilst existing investors engage in capital flight and portfolio substitution (see Collier 1999, Imai and Weinstein 2000 and Collier et al. 2004). The conventional wisdom assumes that the armed conflict-FDI relationship is negative as political instability is bad for business; however, there is sufficient evidence to show that the relationship between armed conflict and FDI is not as simple as the literature suggests.

The central research question

Numerous recent examples, such as armed conflicts in Afghanistan and Iraq, indicate that foreign investors are not uniformly risk-adverse with respect to investments in conflict zones. These examples and the limitations in the current literature have created a research puzzle for understanding the armed conflict-FDI relationship. This thesis focuses on explaining this research puzzle, and addresses the following central research question: *Why do countries involved in internal armed conflict continue to attract FDI?*

The thesis explores the paradoxical nature of the armed conflict-FDI relationship, and suggests that although armed conflict is commonly assumed to deter new FDI, not all foreign investors follow the expected path of behaviour of avoiding armed conflicts. In establishing how foreign investors behave during armed conflict, this thesis examines the effect of an external military intervention (EMI) as an independent variable on FDI, and suggests that foreign investment may be likely to occur during armed conflict when independent states intervene with 'boots on the ground', in contrast to the conventional wisdom in the existing literature. In this respect, this thesis argues that external military interventions which involve 'boots on the ground' encourage FDI through the 'positive signal' it sends to foreign investors. This 'positive signal' stems from the improvements the EMI makes in the investment climate as it brings authority and stability to an incendiary economic and political environment which improves the protection of property rights, thereby mitigating against asset-seizure (through theft or expropriation) or the destruction of property without compensation. The EMI also strengthens investors' confidence by restoring the rule of law, assisting in the reconstruction of economic and political institutions, reducing the level of violence and working towards a lasting end to the armed conflict.

By establishing the armed conflict-FDI relationship, this thesis speaks to debates within two schools of thought which emerge from the broader debate on the economic effects of armed conflict. The first debate is provided by the 'war ruin' school of thought, which suggests that armed conflict has a negative effect on economic, political and social infrastructure as its destructive nature leads to long term negative implications on society. This school includes scholarly works by Russett (1970), Chan (1985), and Diehl and Goertz (1985) as well as the empirical work by Woodward and Rolfe (1993), Schneider and Rey (1985), and Li (2006) on the negative effects of armed conflict on FDI. These authors have argued that armed conflict leads to a series of severe negative economic consequences including inflation, unemployment and surplus labour, increased military expenditure, the diversion of fiscal resources into the war effort, and increased public debt. These effects are not just present during armed conflict but may continue long after hostilities come to an end.

The second debate is provided by the 'war renewal' school of thought. Scholars such as Organski and Kugler (1980) and Olsen (1982) suggest that armed conflict can have a positive impact on the economic, political and social landscape of a country. This school of thought argues that armed conflict can lead to improvements in the economy as it removes elite groups who prevent economic and social development through poor economic management in order to preserve their interest or the interest of their groups. In this context, armed conflict may reduce rent-seeking behaviour and patronage networks which prevent the adoption of technological innovation and the development of human capital, enabling the adoption of policies geared towards efficient economic development and better governance. The occurrence of armed conflict may also provide opportunities for redevelopment as old and poorly laid infrastructure and inefficient industrial plants are replaced by better organised infrastructure and modern industrial

plants, which provide for greater economic growth with long term 'pay-offs' (see Kugler and Arbertman 1989).

This thesis contributes to these debates as it offers empirical evidence to show that: (i) armed conflict does not discourage FDI; and (ii) rates of FDI are more likely to be higher during armed conflict when independent states intervene with 'boots on the ground'. These arguments complement those of the war renewal school of thought, which suggests that armed conflict can have a positive impact on the economic, political, and social infrastructure of a country involved in a continuous armed conflict.

Case selection and methodological framework

The research in this thesis is based on an empirical investigation of the relationship between armed conflict and FDI which uses a multi-method approach and is separated into two parts. Part one consists of a broad quantitative investigation of a large-*N* sample of armed conflicts beginning from 1996 to 2010. Part two consists of a structured focused comparison of Afghanistan and Iraq's armed conflicts, from 2003 to 2012 for Afghanistan, and from 2003 to 2010 for Iraq. In order to triangulate the data, part two also includes a survey on multinational corporations (MNC) attitudes towards armed conflict.

Part one is a quantitative analysis of the armed conflict-FDI relationship which uses secondary data to investigate FDI trends in armed conflict. This investigation is divided into four lines of enquiry. The first line of enquiry establishing whether armed conflict is bad for business as the conventional wisdom in the existing literature assumes that foreign investors avoid armed conflicts because it increases the commercial and non-commercial risks of doing business. The second line of enquiry disaggregates armed conflicts and dichotomises the sample through conflict intensity. The analysis focuses

on whether conflict intensity is a determinant of FDI as the current literature rests on the argument that high-intensity armed conflict deters foreign investors. This is based on the level of risk foreign investor's face when committing to conflict zones, as high-intensity armed conflict present greater losses if the investment is exposed to conflict affected risks.

The third line of enquiry introduces external military intervention (EMI) as an independent variable to FDI. This variable is brought into the investigation to establish whether EMI which includes 'boots on the ground' potentially send a positive signal to foreign investors, which leads to increased FDI. This may occur if the presence of foreign troops facilitates an improvement in the investment climate as an EMI works towards restoring the rule of law, reconstructing economic and political institutions, reducing the level of violence and working towards a lasting end to the armed conflict.

The final line of enquiry examines the impact an EMI has on conflict intensity and whether this affects FDI. As the presence of foreign troops can impact on conflict intensity in a number of ways, its intended impact on FDI could be dependent on whether it is able to reduce conflict intensity. The central argument of this thesis contends that FDI is likely to occur when foreign troops intervene in armed conflict, but this could be based on either foreign investor's following the EMI into an armed conflict or waiting for the EMI to improve the situation before committing their investments. Therefore, establishing how EMI affects conflict intensity can offer important insights into how foreign investors respond to changes in conflict intensity under an EMI.

Although part one is a broad investigation of the armed conflict-FDI relationship, part two takes a more focused approach in furthering how armed conflict affects FDI, and

how EMI influences foreign investors. Part two uses a structured focused comparison of the case studies of Afghanistan and Iraq. By disaggregating armed conflict and FDI data it attempts to understand whether the distribution of FDI in armed conflicts can be explained by: (i) the spatial dynamics of armed conflict; (ii) the size and sector of the investment; or (iii) the origin of the investment.

The structured focused comparison is divided into three further lines of enquiry, beginning with an examination of how the spatial dynamics of armed conflict affects FDI. The spatial dynamics of armed conflict refers to the geographic spread of armed violence which determines whether an armed conflict is isolated or widespread. *Isolated armed conflicts* are conflicts where armed violence is confined to remote parts of the country, whereas *widespread armed conflicts* are geographically spread with armed violence spilling-over into commercial and investment intensive areas. Each type of armed conflict presents a different level of risk with the conventional wisdom suggesting that widespread armed conflict present far greater risks to the investor as it puts the investment in close proximity to armed conflict (see Berman 2000). Therefore, the examination here focuses on whether foreign investors avoid widespread armed conflicts.

The second line of enquiry focuses on the size and sector of the investment. The analysis examines whether the size of the investment is a determinant of FDI and whether the distribution of FDI can be explained by the sectors that attract FDI. The existing literature suggests that investments in armed conflict are small in nature as these represent fewer risk to foreign investors if the investment is destroyed, lost (through market failure) or stolen (through theft and expropriation). In contrast, large investments are assumed to be infrequent as they require more resources, have heavy operational basis and require access to big markets, which increases the scale of losses

if the investment is exposed to conflict affected risks, including the contraction of domestic markets. Additionally, the size of the investment is expected to determine the sectors which attract FDI, as the literature argues that capital intense sectors often struggle to attract FDI because they require heavy resources. These sectors include engineering, construction, natural resources, real estate, telecommunications and transportation (see Berman 2000). The examination of these dynamics in this thesis focuses on whether the size of the investment is a determinant of FDI, and whether FDI in armed conflicts can be explained through the sectors which appeal to foreign investors.

The third line of enquiry examines whether the geographic origin of investment can explain the distribution of FDI in armed conflicts. This is premised on two factors which include foreign investors 'following the flag' (see Biglaiser and Derouen 2007, p. 836) and foreign investors taking advantage of the 'near home bias' (see Levis et al. 2010, p. 3). The logic of investment 'following the flag' emerges from the EMI literature, which contends that as military interventions are motivated by economic interests (see Pearson 1974, Carment and Rowlands 1996, and Carpino 2006), the investment climate is often dominated by investors who follow their countries' participation into armed conflicts. The opposing perspective is provided by the finance literature which puts forward the 'near home bias' as being influential in attracting FDI. This concept argues that the close proximity between the investor and the investment destination offers logistical and transaction advantages as well as information advantages for investors in neighbouring and regional countries over investors further afield, who may face greater information asymmetry problems. This close connection suggests an element of cultural, institutional and social familiarity (see French and Poterba 1991 and Huberman 2001) which in the context of armed conflict implies that

the investment destination is dominated by investors from neighbouring and regional countries. Therefore, the third line of enquiry examines whether military contributions or geographic proximity between the investor and the investment destination can explain FDI in armed conflicts.

And finally the thesis triangulates the data in the above investigations by presenting survey evidence of multinational corporations (MNCs) attitudes towards political risks which include policy and security related threats. The survey provided by the World Bank offers nuanced arguments on how MNCs view political risks and in particular armed violence, and whether it features in the decision making process of MNCs when selecting a location for their investments.

Structure of the thesis

This thesis is structured as follows. Chapter two provides a review of the literature beginning with the broader literature on the negative effects of armed conflict to economic processes including economic growth and FDI. It then examines how armed conflict leads to reduced levels of FDI and capital flight, before providing empirical evidence for why the complex dynamics of the armed conflict-FDI relationship require greater explanation than the existing literature thus far offers. The chapter then explores the literature on FDI, and identifies the main reasons why foreign investors might – counter intuitively – decide to make investments in armed conflicts. Chapter 2 then concludes with a discussion on the independent variable of external military intervention (EMI).

Chapter 3 provides the methodological framework for the thesis. This chapter puts forward a rational for the data sample, including discussion of the reasons why internal armed conflicts have been chosen over international and interstate armed conflict, and

why Afghanistan and Iraq have been selected as the primary case studies. This chapter discusses the methodological challenges facing this thesis, and how these have been mitigated using a multi-method approach.

Chapter 4 begins the first part of the empirical investigation of this thesis. This chapter is a large-*N* quantitative analysis of internal armed conflict beginning from 1996 to 2010. This chapter uses descriptive statistics to demonstrate that armed conflict does not have a negative effect on FDI, with foreign investors likely to take advantage of market opportunities created through armed conflict if independent states intervene with 'boots on the ground'. It concludes by putting forward empirical evidence to show that FDI may increase in armed conflicts in the context of military intervention even if the EMI leads to no changes in conflict intensity.

Chapter 5 is the second part of the empirical investigation. This chapter offers a structured focused comparison of the armed conflict-FDI relationship by disaggregating FDI and armed conflict data in Afghanistan and Iraq. This chapter follows three lines of enquiry, and examines empirical evidence which shows that foreign investors do not uniformly avoid widespread armed conflict. Moreover, the chapter demonstrates that the size of the investment and the sectors which attract FDI cannot explain the distribution of FDI in armed conflicts, while there is evidence of investors 'following the flag' and taking advantage of the 'near home bias'. However, as the chapter shows, there is no evidence that investment volumes correlate with military contributions, which suggest that 'free-riding' is evident when independent states intervene in armed conflicts. Chapter 5 then discusses the results of a survey on MNCs attitudes towards political risk and shows that security related threats which include armed violence, civil disturbance and terrorism do not feature highly in the decision making processes of MNCs when selecting a location for their investments, and does not lead to disinvestment or the

cancellation of future investments. Chapter 6 concludes by summarising the results of the empirical investigation and discussing its meaning within a wider context. This chapter discusses the contribution of this thesis and areas which require further research.

CHAPTER 2: THE NEGATIVE EFFECTS OF ARMED CONFLICT ON FDI

2.1 Introduction: Is armed conflict bad for business?

In the aftermath of the end of the Cold War two trends have altered the dynamic relationship between armed conflict[1] and flows of foreign direct investment (FDI). The first is the decline in the frequency of armed conflict since the end of the Cold War; the second is the growth of globalisation in the same period, which has brought a greater exchange of international trade and finance. Armed conflict is often defined 'as a contested incompatibility that concerns government and/or territory where the use of armed force between two parties, of which at least one is the government of a state, results in at least 25 battle-related deaths'.[2] This is often seen as the most challenging form of political instability, which has a detrimental effect on economic, political and social development. Within this broad category, intrastate conflict is the most virulent form of armed conflict, which is often seen as 'development in reverse' (see Collier 2004). Intrastate conflict is predominately located in fragile developing countries (see Murdoch and Sandler 2002a) that are characterized by weak political governance, social fractionalisation and poor economic management.[3]

Despite the greater level of volatility and instability that may exist in developing countries, over the past three decades developing countries have emerged as important destinations for foreign investors seeking higher returns (or greater market share) from expanding into new markets. This has led to an increase in flows of FDI to developing countries, which according to the United Nations Conference on Trade and

[1] Armed conflict refers to all types of conflict from interstate, decolonisation, intrastate and internationalised intrastate conflict.
[2] The definition of armed conflict is taken from Themnér and Wallensteen (2011) and the UCDP/PRIO Armed Conflict Dataset.
[3] For a breakdown of armed conflict by type see Buhaug et al. (2007).

Development (UNCTAD), accounted for almost 50% of total global FDI in 2010.[4] This suggests that foreign investors are increasingly attracted to developing countries as potential areas for investment.

Foreign investors are consumers of the investment environment while the host country acts as the supplier, often competing with other countries for much needed financial capital. Many developing countries which compete for foreign investment often market themselves through outreach initiatives such as Investment Promotion Agencies (IPAs). This involves a deliberate effort to demonstrate their willingness to provide an investment climate that is favourable to foreign investors, which may include lower costs of entry, lower investment taxes and the free movement of financial capital for the repatriation of profits. Although these methods act as incentives for foreign investors, additional factors such as market size, growth potential (see Bevan and Eastrin 2000, and Resmini 2000) and natural resource accessibility (Asiedu 2006) act as pull factors for FDI. Yet while these factors are important to foreign investors, the degree of political stability in a country is a key driver of foreign investment, and a deteriorating political environment often prompts foreign investors to seek alternative destinations elsewhere.

Armed conflict is the most extreme form of political instability, and has severe repercussions on the investment climate as it increases the commercial and non-commercial risks of doing business. This includes: (i) the potential destruction of the investment; (ii) the risk of theft resulting from either expropriation, when governments change the rules of the game (see Mihalache 2011), or when a breakdown in the rule of

[4] The mean values of FDI data from 1970 until 2010 also support this argument. For instance over 10 year cycles beginning from 1970-1979, 1980-1989, 1990-1999 and 2000-2009, the mean values of FDI as a percentage of world total for developing countries are 24.9%, 25.2%, 30.7% and 31.6% with a standard deviation of 3. For industrialised countries the mean values over the same year cycles are 74.9%, 74.38%, 68.1% and 64.7% with a standard deviation of 4. Even though industrialised countries still receive a larger proportion of total FDI, the mean values show that after each 10 year cycle average FDI inflows have decreased in industrialised countries whilst it has risen in developing countries. Original data for FDI inflows is taken from the United Nations Conference on Trade and Development [http://unctad.org/en/Pages/Statistics.aspx].

law leads to looting; and (iii) losses that may be incurred through market failure/contraction or through a breakdown in agreements/commitments with local partners. These risks have directed contemporary scholarship on the armed conflict FDI-relationship to argue that armed conflict is bad for business, as foreign investors are unwilling to accept the higher risk premiums associated with investments in conflict zones (see Asiedu 2002, and Pierpont and Krueger 2005).

Although existing arguments in the theoretical literature indicate that armed conflict discourages FDI, sufficient evidence has emerged to show that the relationship is not as simple as the literature suggests. This empirical evidence points to the growing number of investment examples in armed conflicts, which demonstrate that the risks associated with armed conflict do not serve as a consistent deterrence to all foreign investors. This suggests the need for greater in-depth research to explore whether armed conflict is bad for business, and to identify the reasons why foreign investors may decide to invest in countries despite the instability associated with armed conflict.

2.1.1 Overview of the chapter

This chapter is structured as follows. It begins by discussing the core research puzzle before outlining the main contribution this thesis aims to make to the existing literature in the field. As FDI is a key determinant of economic growth, this chapter will focus on the broad discussion of the theoretical and empirical evidence on the economic consequences of armed conflict, before looking at how armed conflict impacts on different dimensions of economic stability and growth. Once the armed conflict and economic growth context has been explained, the chapter will focus specifically on outlining the political economy of FDI. This discussion will proceed by briefly explaining the importance of FDI in the growth process for developing countries, and

how these countries can continue to attract foreign investors despite their economic and political weaknesses. This will leads to an examination of the nexus between internal armed conflict and FDI, which will explain how domestic and international investors including holders of liquid capital can engage in investment substitution and capital flight when faced with the onset of armed conflict, drawing on theoretical arguments from the international business and political science disciplines.

Following on from this, the next section will outline some of the challenges and risks foreign investors may consider when selecting conflict zones as investment destinations. As considerable investment risks exist in conflict zones, and the existing theoretical literature assumes that foreign investors are deterred by internal armed conflict, the next section provides a brief illustration of country specific data which show that a counter intuitive trend exists as foreign investment continues to flow into conflict zones. In presenting this evidence, this section also offers some possible explanations for this risk-adverse behaviour which includes investment strategy to risk management. The final section of this chapter examines the potential significance of external military intervention on FDI trends, and provides a brief overview of the literature on how the presence of foreign troops can potentially facilitate FDI into conflict zones. This chapter concludes with a brief summary of the research puzzle.

2.2 The research puzzle

The widespread belief in the academic literature that armed conflict is bad for business comes from the 'war ruin' school of thought, which argues that armed conflict is destructive in nature as it disrupts economic, political and social infrastructure. This school includes scholarly works by Russett (1970), Chan (1985), and Diehl and Goertz (1985) as well as empirical work by Woodward and Rolfe (1993), Schneider and Rey

(1985), and Li (2006) on the negative effects of armed conflict on FDI. These scholars argue that armed conflict has long term negative consequences for economic development as it causes inflation, leads to unemployment and surplus labour, increases military expenditure, diverts resources into the war effort and results in states assuming greater levels of sovereign debt.[5] These effects are not only present during armed conflict, but may continue long after hostilities come to an end. Although this school dominates the literature in the field, an opposing view is provided by the 'war renewal' school of thought. This school is less well-developed, and includes the works by Organski and Kugler (1980) and Olson (1982). The core argument from the 'war renewal' perspective is that the destructive nature of armed conflict can have a positive impact on the economic, political and social landscape of a country as it can remove elite groups who prevent economic and social development through poor economic management in order to preserve their own interests and renk-seeking opportunities. In this context, armed conflict can potentially reduce the rent-seeking behaviour and patronage networks which might prevent the adoption of technological innovation and reduce the development of human capital, enabling the adoption of policies geared towards efficient economic development and better governance. The occurrence of armed conflict may also provide opportunities for redevelopment as old and poorly laid infrastructure and inefficient industrial plants are replaced by better organised infrastructure and modern industrial plants, which provide for greater economic growth and long term pay-offs (see Kugler and Arbertman 1989).[6]

In the examination of how foreign investors react to the initiation and continuation of armed conflict, the theoretical arguments in the existing literature that are discussed later in this chapter support the view that foreign investors are deterred by armed

[5] For a good overview of how reductions in military expenditure can lead to positive GDP growth see Knight et al. (1996).
[6] However it must be noted that the war renewal school's ideas are concerned with the peace dividend which is applicable to post-conflict reconstruction rather than how business can flourish during war time (see Kang and Meernik 2005).

conflict. However, recent examples of foreign investments in countries experiencing armed conflicts generate a research puzzle which the existing literature struggles to explain. This constitutes the core research puzzle which is explored in this thesis. While it may seem obvious that foreign businesses prefer to invest resources in stable and peaceful environments, examples where foreign investment continues to flow into countries affected by armed conflict challenge conventional understandings of the factors that determine investment decisions by mobile foreign investors. For instance, FDI has continued to flow in the oil fields of the Niger Delta despite its armed conflict.[7] In Iraq, the international armed conflict in 2003 and subsequent internal armed conflict in 2004 did not result in decreased FDI flows as foreign investors continued to make investments in its natural resource sector (see Wulandari 2012), while the armed conflict in Afghanistan has not deterred foreign multinational corporations (MNCs) from tendering for contracts to develop its vast oil and minerals deposit, even though some of these resources are located in the heart of its armed conflict (see Gienger and Martin 2012).

The examples cited above are exclusive to the natural resource sector, which requires intense and long-term capital investment which is highly vulnerable to asset destruction and potential losses if foreign assets are expropriated. Despite the risks, however, the evidence suggests that foreign investors view these sectors as lucrative investment opportunities because of the unique characteristics the natural resource sectors possess, which mitigate the commercial and non-commercial risks that armed conflict presents.

[7] The armed conflict in the Niger Delta has risen over the resource rich region between the minority ethnic groups and the multinational oil corporations (MNOCs). Being the major source of oil revenue that accounts for about 96% of state foreign earnings and about 85% of state revenues, the region is by far the most central to the nation's economic and political survival. But, paradoxically, the region is one of the poorest, least industrialised and least reciprocated for its contributions to national wealth. The contradiction of wealth generation amidst poverty has generated anger, frustration and hostility to the state and the foreign companies which exploit the region. The result has become the construction of a terrain of violent protests, disruption of oil production; seizures of oil platforms, installations and equipment, kidnaping of foreign workers, confrontation with state security forces and militarisation of the region (see Ikelegbe 2001). There is an abundance of literature arguing how natural resources lead to the onset of intrastate conflict. For a thorough discussion see Collier and Hoeffler (1998, 2004, and 2005), Fearon and Laitan (2003), Ross (2004), and Fearon (2005).

For instance, as the commodity value and scarcity of natural resources offers no substitute locations, foreign investors face strong incentives to compete to secure unexploited natural resources in order to gain the benefit of 'first mover advantage' (see Patey 2006). Securing natural resources during armed conflict is therefore of strategic importance to foreign investors operating in this sector. Although investments in this sector are vulnerable to asset destruction, the militarization of natural resources and the high export value act as pull factors for adventurous foreign investors who are willing to accept a higher risk profile. As natural resources are concentrated in frontier regions, their vulnerability towards asset destruction can be reduced through increasing security by employing private contractors (see Hirsch and Vidal 2012)[8] or through host governments securitising resource rich areas (see Renner 2002, Le Billon 2004, and Holden and Jacobson 2007). As resource revenue also finances military expenditures (see Human Rights Watch 2003) host governments have an incentive to protect operational bases and to prevent any disruption to the extraction and exportation of natural resources (see Renner 2002, Le Billon 2004 and Holder and Jacobsen 2007).[9] In addition, losses from market failure/contraction can be reduced as the natural resource sector is typically export-oriented, so investors simply increase exports to compensate for reduced demand in local markets.

Despite the high prospective rewards the natural resource sector offers, it is still surprising that these investments occur in conflict zones where investors potentially face an 'all-or-nothing' bet on the likelihood of maintaining ownership and control of their assets. Even more surprising is that there is a far greater distribution of FDI into non-resource sectors, which are typically seen as far riskier than investments in the natural

[8] For instance Shell is able to allocate significant resources for the protection of its investments in the hostile Niger Delta where according to leaked reports it has spent almost $383m over the past three years (see Hirsch and Vidal 2012).

[9] Although the investment can be secured, the investment is not completely risk free as it is reliant on transport networks to take the product from the extraction point to the market. This is often done through oil and gas pipelines which are vulnerable to frequent attacks especially if they run through remote areas which are outside of government control. Therefore, although foreign investors can reduce their exposure to conflict affected risks, they incur losses if they are unable to get the product to the market.

resource sector. This includes investments in Iraq where foreign investors have heavily invested in the financial services sector, such as the $10 million investment by CHF International in 2008 in developing the local business markets (see OPIC annual report 2008, p. 17). In Afghanistan, US companies have set up production facilities including ABI Group LTD, which made a $9.2 million investment in setting up a beverage plant (see OPIC annual report 2004, p. 10) in 2004, as well making investments in hotels, roads and infrastructure (ARC Construction Company, LLC - $5.4 million - see OPIC annual report 2004, p. 10). In Pakistan, where the fall-out from the armed conflict in Afghanistan has led to an internal armed conflict with various terrorist groups, this has not deterred foreign investors making significant investments in its non-natural resource sector. This includes GE International's $29 million investment in developing the country's mobile power generation (see OPIC annual report 2007) in 2007.[10]

These examples indicate that foreign investors still see market potential in countries experiencing armed conflicts, which is not confined to the natural resource sector. They also problematize the assumption in the existing scholarly literature that conflict is uniformly bad for business. Although the distribution of FDI in the natural resource sector might be explained by its unique characteristics which mitigate some of the risk, the reasons for why FDI occurs in armed conflicts need to be identified and disaggregated in a more comprehensive fashion. The lack of a clear explanation in the literature for foreign investment in conflict zones underscores the need both to clarify dynamics that underpin the armed conflict-FDI relationship, and the reasons why foreign investment may occur during armed conflict.

[10] According to UCDP/PRIO 'Armed Conflict Dataset 1946-2010' (see Themnér and Wallensteen 2011) Iraq, Afghanistan and Pakistan were officially involved in a lengthy conflict at the time the investment was made; Iraq: 2003-2010, Afghanistan: 1996-2010, and Pakistan: 2004-2010. Therefore the decision of foreign investors to commit to the investment was made with the knowledge that the destinations were politically unstable.

2.2.1 The variable – External military intervention (EMI)

This thesis puts forward external military intervention (EMI) as an independent variable to FDI and suggests that foreign investment is likely to occur if independent states intervene. In this respect, external military interventions which involve 'boots on the ground' potentially send a 'positive signal' to foreign investors. This can facilitate an improvement in the investment climate by bringing authority and stability to an incendiary economic and political environment which increases investors' confidence as the EMI ensures the protection of property rights, thereby mitigating the risk of asset-seizure or the destruction of property without compensation. The EMI also works towards repairing investors' confidence by restoring the rule of law, assisting in the reconstruction of economic and political institutions, reducing the level of violence and working towards a lasting end to the armed conflict.

2.3 The negative effects of armed conflict on economic growth

As the natural reaction of international business is to avoid armed conflict, it is a rational assumption then to believe that war is bad for business. Many scholars have tried to make sense of the negative effects of armed conflict through either quantitative or qualitative methods and most agree in principle that war is detrimental to society (see Modell and Haagerty 1991, McKay 1998, Murray et al. 2002, Raleigh and Urdal 2007, Justino 2009 and Shakya 2009) with ramifications extending to economic processes. When looking at the economic consequences of armed conflict, one has to bear in mind that the scholarship is split between studying how armed conflict affects economic growth during wartime and how armed conflict radically overhauls political, social and economic infrastructure to improve economic efficiency post-war. Although the intuitive belief linking armed conflict to economic growth suggests a strong negative

association, the reverse relationship seems equally credible, and as most scholars attempt to base their analysis on the net effect of armed conflict by looking at post-conflict economic recovery.[11]

Keeping the analysis confined to just the impact of armed conflict to economic growth suggests that the overall relationship is negative as armed conflict destroys infrastructure and industrial plants, disrupts the flow of trade and finance, diverts resources into the war effort and depletes existing capital stock. The culmination of these effects leads to armed conflict having a strong negative impact on economic growth and there is significant historical evidence documenting how countries affected by armed conflict suffer from declining economic growth. For instance, looking at war and the economic performance of major powers, Kuznets (1964, 1971) observes that the two most prominent conflicts of the twentieth century led to huge economic losses for countries which were invaded during the second world war (e.g. Germany, the Soviet Union, Japan and France). Wheeler (1975) discovered that despite significant post-war output and accelerated growth rates being recorded in 60 cases from 1816 to 1965, the immediate impact of armed conflict led to negative economic performance. And Organski and Kugler (1977, 1980) showed that despite the presence of the 'phoenix factor'[12] the two world wars led to significant losses for winners and losers of the conflict, which was consistent with the results of Kuznets. Koubi (2005) found a similar pattern for interstate conflicts. Studying conflicts from 1960-89, Koubi found that the more severe the conflict the greater the destruction to economic growth. Although these

[11] Most studies which look at post-conflict economic recovery agree that countries affected by armed conflict recover sufficiently to levels above the rate of economic performance before the conflict. For interstate conflicts see Organski and Kugler (1980), Olson (1982) and Koubi (2005) and for intrastate conflicts see Collier and Hoeffler (2002b, 2002c), Collier et al (2003), Kang and Meernik (2005). For a review of the literature on post-conflict economic recovery see Rasler and Thompson (1985) and Van Raemdonck and Diehl (1998).

[12] The crux of the phoenix factor claims that despite the indisputable losses losers suffer compared to winners of a conflict, in the long run losers catch up with winners in terms of power capabilities. The mechanics of the phoenix factor work in the following way: Winners see a slow rate of recovery compared to losers whose recovery exceeds that of winners, whilst neutral see no difference. As losers have a far greater rate of recovery, "losers appear almost literally to rise from the ashes of their defeat - this is a phoenix factor at work" (see Organski and Kugler 1980, pp. 106-7).

studies found armed conflict to have a negative effect on economic growth, they all agreed that post-conflict recovery accelerated with Koubi (2005) arguing that the longer and the more severe the conflict the higher the subsequent post-conflict recovery.

When we try to connect the economic growth of countries suffering from internal armed conflicts which occur primarily in developing countries, it is not surprising that the trend follows in the natural relationship already developed in interstate conflicts. Unlike the conflicts seen in Europe, internal armed conflicts are 'not wars of conquest that threaten the existence of other states, but conflicts that are fought over lesser issues that are resolved without threatening the existence of another state' (see Herbst 1990, p. 123). Therefore, these armed conflicts are liable to be far more damaging than interstate armed conflicts (see Collier 1999).[13]

There is a good level of scholarly studies which calculate the economic cost of internal armed conflicts which will be discussed in the next section. However, the theoretical underpinnings connecting internal armed conflict to economic growth support the overall generalisation that war is bad for business. For instance, Kang and Meernik (2005) analysed economic growth rates for countries involved in civil conflict from 1960-2002 and found that there was no divergence from the already held belief that armed conflict had negative economic consequences. The authors found that the longer and more destructive the conflict, the greater the impact on economic growth. Koubi (2005) found that countries which experienced civil conflict had a less than satisfactory economic performance than other countries whilst Imai and Weinstein (2000) also found a negative economic effect arguing that as civil conflict spreads geographically, the negative effect on economic growth also increased. This was also supported by Murdoch and Sandler (2002a, 2002b) who found that the negative spill-overs were felt

[13] Though they may be more damaging than interstate conflicts, they are often fought with much lower technology so tend to be less destructive, at least of physical capital (see Collier 1999).

as far as 800km from the actual conflict with a strong correlation between conflict intensity and collateral damage suffered by neighbouring countries.[14] Groot (2010) argued that proximate conflicts only affected neighbouring countries negatively if they were contiguous to conflict. The author also found some positive trade-off benefits.

Collier (1999) provides a very good understanding on how civil conflict strips a country of its economic growth by investigating its effect on GDP and its composition. Collier argues that civil conflict damages the economy through the destruction, disruption, diversion and dissaving effect. The most obvious way in which civil conflict strips economic growth is through the destruction it causes on physical and human capital as civil conflict kills people and destroys infrastructure including production plants. The second effect is the disruption it causes to everyday life through the destruction on infrastructure such as making roads unsafe and homes inhabitable and therefore incurring additional costs and reducing the efficiency of public expenditure (see Isham et al. 1996). A third effect according to Collier is the diversion of resources into the war effort. As conflict ensues, the state diverts resources from 'output-enhancing activities' such as education and health into the war effort, therefore diminishing the functioning of the public sector. This also includes shifting resources from the police force which diminishes its power and leads to the loss in the rule of law culminating in 'enforcement costs of contracts to consequently rise and security of property rights to be reduced' (see Collier 1999 p. 169; emphasis in original text).[15] The above effects lead to a loss in income for the state which is temporary; however, the final effect stemming from dissaving has an impact which is felt in post-conflict recovery.

[14] Though civil conflicts are supposedly confined within the borders of the state, it is unlikely that the consequences will be solely confined to the state in turmoil and will affect neighbouring countries through spill-over effects. The authors argue that negative effects of civil conflict reduces the income per capita and growth of neighbouring countries through causing collateral damage from battles close to borders that destroy infrastructure and capital; increasing the perceived risks to would be investors and diverting foreign investors away from neighbours at peace; disrupting cross border trade and severing input supply lines; as well as expending resources to secure their borders from rebel incursion – an action that may lead to less productive use of resources. And the refugees which cross over the border could increase labour supply thus reducing per capita income through migration. See also Millet (2002) and Groot (2010).

[15] For an overview of the costs of expenditure diversion arising from war, see Knight et al. (1996).

As the destruction from armed conflict leads to economic collapse and a reduction in income, the state borrows money for the war effort against future earnings which has a lasting impact especially if this is coupled with capital flight including both financial and human, thus taking longer to recover. In assessing the destructiveness of civil conflict on economic growth, Collier argues that countries lose an average of 2.2% of GDP per capita which is partly because the conflict reduces production and partly because it causes a gradual loss of the capital stock from the effects described above. Collier also investigated how individual sectors react to civil conflicts and finds that sectors which require intensive capital such as construction, transport, distribution and finance suffer more than sectors which require less capital such as arable subsistence agriculture.[16]

In earlier studies connecting armed conflict to economic growth, post-conflict recovery accelerated in countries affected by interstate armed conflict and despite the immediate strong negative effects, armed conflict did bring some positive constructive effects once hostilities came to an end. This suggested the presence of the 'phoenix factor' (see Organski and Kugler 1980, pp.106-07) and held claim of the 'war renewal' school of thought that armed conflict can improve societies through removing the barriers which impede social and economic development. Collier (1999) did attempt to investigate whether this also applied to civil conflicts and found that the restoration of peace did not bring a peace dividend as was expected. Instead of leading to post-war recovery the destructive nature of civil conflict led to a higher burden in military expenditure and war overhang where the rate of growth continued to spiral downwards by 2.1% per annum which increased the risk of renewed conflict.[17] This conflicted with later studies by

[16] Collier has categorised sectors as being vulnerable (arable subsistence agriculture), invulnerable (construction, distribution, finance, manufacturing and transport) or unclassified.

[17] From a policy perspective in preventing renewed conflict Collier and Hoeffler (2002b and 2002c) identify that foreign aid in good policy environments contributes towards preventing renewed conflict as it diversifies the economy by making it less dependent on

Murdoch and Sandler (2002a) who found that states most destroyed by civil conflict rebounded more fully, whilst Koubi (2005) postulated that the more severe or longer the conflict the higher the subsequent, medium term economic growth.

2.4 The cost of armed conflict and the stripping of growth

So how does armed conflict strip a country of its growth potential and what are the costs states must incur when involved in an internal armed conflict? Collier (1999) has already measured the cost of conflict and suggests that during civil conflict the annual growth rate is reduced by 2.2%, with a 15 year conflict reducing per capita GDP by around 30%. Other scholars have attempted to understand the negative consequences of armed conflict by trying to examine the costs that states will incur in fighting durational conflicts with estimates ranging from 0.4% of growth lost per year in Guatemala (see Stewart and Humphreys 1997) to 90% of growth lost as measured by Lopez (2001) in Nicaragua's civil conflict. The table below shows the economic costs of various internal armed conflicts.[18]

Table 2a. Empirical studies on the economic costs of internal armed conflict

Author	Country	Conflict period	No. of years	Cost of conflict	Yearly % reduction of GDP
Fitzgerald 1987	Nicaragua	1980-84	5	77% of GDP 1984	15.4
Richardson a Samarasinghe 1991	Sri Lanka	1983-88	6	68% of GDP 1988	11.3
Grobar & Ginansaelvam 1993	Sri Lanka	1983-91	9	20% of GDP 1988	2.2
Stewart & Humphreys 1997	El Salvador	1965-90	26	38.1% of GDP 1965	1.5
	Guatemala	1965-90	26	9.9% of GDP 1965	0.4
	Nicaragua	1965-90	26	113.4% of GDP 1965	4.4
	Ethiopia	1965-90	26	28.8% of GDP 1965	1.1
	Uganda	1965-90	26	58.6% of GDP 1965	1.1

primary commodity exports (the link between primary commodity exports and civil conflict onset is well established, see Collier and Hoeffler 2004, Fearon 2005, Lujala et al. 2005, Ron 2005, and Varisco 2010). Collier and Hoeffler also establish that foreign aid in conjunction with good policies begin to yield positive growth in the fourth year of peace. Kang and Meernik (2005) build on this work by concurring in their investigation that despite the losses incurred during conflict, post-conflict recovery accelerates though this is dependent on various factors. In their study they found that regime change, democracy, the presence of UN peacekeepers and better macroeconomic management led to better growth output levels. Siegel (2010) disputes that the presence of UN peacekeepers can improve post-conflict growth and argues that the UN will most likely only intervene in conflicts where post-conflict recovery is likely to be robust.

[18] There are some discrepancies between authors on the costs of similar conflicts which are due to different calculating methods. The principle methods include either a modelling method or an accounting method. For a summary of the different methods see Lindgren (2005).

	Sudan	1965-90	26	+7.2% of GDP 1965	+0.3
	Liberia	1965-88	24	35.1% of GDP 1965	1.5
	Mozambique	1980-90	11	31.8% of GDP 1965	2.9
DiAddario 1997	Nicaragua	1980-87	8	17.3, 18.2. 19.6, 25.7% of GDP 1980-85	17.3
Harris 1997, 1999	Sri Lanka	1983-92	10	88% of GDP 1982	8.8
Kelegama 1999	Sri Lanka	1983-94	12	131% of GDP 1995	10.9
Collier 1999	19 countries	1960-89	30	-	2.2
Stewart, Huang & Wang 2000	Angola	1974-95	22	1.48% of GDP 1995	0.1
	Ethiopia	1973-95	23	3.95% of GDP 1995	0.2
	Liberia	1984-95	12	1.56% of GDP 1995	0.3
	Mozambique	1980-95	16	2.83% of GDP 1995	0.2
	Sierra Leone	1990-95	6	1.47% of GDP 1995	0.2
	Somalia	1987-95	9	0.29% of GDP 1995	0
	Sudan	1983-95	13	1.72% of GDP 1995	0.1
	Uganda	1970-90	21	0.5% of GDP 1995	0
	El Salvador	1978-95	18	5.67% of GDP 1995	0.3
	Nicaragua	1977-93	17	13.5% of GDP 1995	0.8
Arunatilake, Jayasuriya & Kalegama 2001	Sri Lanka	1984-96	13	140% of GDP 1996	10.8
		1984-97	14	168% of GDP 1996	12.9
		1984-98	15	205% of GDP 1996	15.8
Lopez 2001	El Salvador	1979-91	13	1100% of GDP 2000	84.6
	Nicaragua	1978-79, 81-88	11	900% of GDP 2000	90
	Guatemala	1966-96	31	425% of GDP 2000	13.7
	Panama	1989	1	85% of GDP 2000	85
Dorsey & Opeitum 2002	Uganda	1995-02	8	57% of GDP 2002	7.1
Abadie & Gardeazabal 2003	Basque Country	1975-97	23	10% points decline	-
Hoeffler & Reynal-Querol 2003	78 countries	1960-99	40	2.4% of yearly growth rate	-

Source: Lindgren 2005, p.62, Table 3 - Empirical Studies of the Economic Costs of Internal Armed Conflict.

These costs are calculated by observing growth lost during armed conflict which many scholars argue arises from increased military expenditure, destruction of infrastructure, looting and destruction by soldiers, loss of private capital and increased criminality (see Collier et al. 2003, Collier and Hoeffler 2004, and Sköns 2005) with the purpose being to develop a rounded assessment on the destructive nature of armed conflict. We already know from the table above that internal armed conflict is costly and that it leads to losses in economic growth but how does it strip a country of its growth potential? The table below shows some of the economic consequences of armed conflict.

Table 2b. Types of economic consequences of armed conflict

Economic dimension	Effect
Economic growth	Negatively affected but aggregate output is least affected where the conflict is isolated to one geographic location and away from the commercial areas. The agriculture sector is particularly affected by civil conflict in developing countries because of forced displacement as people are forced to move to avoid violence.
Exports	Negatively affected which partly stems from a fall in production because of the shift towards domestic markets in order to sustain domestic consumption in the face of falling production and partly from disruptions in international markets. Import capacity holds up at first - often growing even though exports fall. This is due to the availability of foreign aid and availability of aid. Foreign exchange tends to be diverted towards military expenditure and essential consumption leading to a shortage of foreign exchange for economic inputs.
Sector distribution	Sector shift from tradable to non-tradable sectors because of market disruptions, including undermining of formal organisations such as banks and failure of transport systems. One of the major consequences of conflict is the switch form formal to informal activities (particularly smuggling).
Consumption	Negatively affected as with per capita GDP despite reduced domestic savings and increased foreign borrowing and aid dependence.
Domestic and foreign investment	Negatively affected as government capital formation and foreign and domestic investment falls amidst increased economic uncertainty and political instability. This uncertainty also leads to domestic and foreign capital flight which is a serious problem as capital flight is detrimental for capital formation which is important to economic growth.
Budget deficit	Increase due to increased spending and reduced government revenue from taxation.
Distribution of government spending	Increased share allocated to the military at the expense of social and economic expenditure with the share of social expenditure falling quite severely.
Civic entitlements	Civic entitlements replace lost public entitlements through Non-governmental organisations efforts to provide food and medical aid.
Human Costs	As a result of falling entitlements, there are heavy human costs including death, increases in infant mortality rates and deteriorating nutrition, health and education standards. Forced migration leads to increased and persistent poverty and war-induced famines.[19]
Development costs	Heavy development costs arise from conflict due to all types of capital (physical, human and financial) being subjected to destruction and reduced investment.

Source: Stewart and FitzGerald (2001, pp230-232) and Lindgren (2005, p. 54)

2.5 The importance of FDI to economic growth

The above section has supported the theoretical arguments that internal armed conflict dramatically reduces economic growth and the above table shows the means in which it strips a country of its growth potential. Specifically concentrating on FDI, internal armed conflict deters foreign investors because of the heightened risks which lead to

[19] On how armed conflict leads to poverty see Bruck and Binzel (2006); on labour shortages within households see Ghobarah el al. (2003); on health see World Health Organisation (2002); and on forced migration see USCR world refugee survey (2006).

capital flight of existing investments and deters potential investors who chose alternative safer investment destinations (see Collier 1999). As FDI is an important mechanism in the growth process, in particular for developing countries, it is worth summarizing how foreign investments can stimulate economic growth as well as how developing countries with uncertain economic and political stability can facilitate FDI.

The importance of FDI to economic growth for developing countries can be best understood through economic theory which namely suggests that FDI generates employment through increasing productivity; improving local firms' productivity through fostering efficient use of resources; improving technological advances and transmission of ideas; and gives access to export markets through increased international trade. The economic benefits of FDI for developing countries are considered to be two-fold; firstly, FDI provides much needed international capital which helps to maintain and expand the capital stock of a country (factors of production such as residential structures, machinery, factories and equipment that exist at a point in time and add to the productive power of the economy) as MNCs set up production facilities, employ local workers and source out local firms in supplying materials etc. And secondly, the spill-over effects through the presence of a foreign affiliate increases the competitive pressures in the home market for local firms which are forced to adopt new technologies and ideas (see Mencinger 2003 and Carkovic and Levine 2005) and become more efficient in the allocation and distribution of their resources.

In regards to the spill-over effects, foreign affiliates act as a 'conduit for transferring technology from the industrialised to developing countries' (see Lim 2001, p. 3) as developing countries often lag behind industrialised countries in the adoption of technology which prevents economic development and often leads to a widening gap between industrialised and developing countries (see Borensztein et al. 1998). As

MNCs are considered to be a major channel in accessing advanced technologies, it is imperative for developing countries to create conditions for MNCs to enter the host market as the transfer of technology can play a pivotal role in the process of economic development through helping developing countries 'catch-up' with industrialised countries. This development occurs through a contagion effect where new ideas and technologies are transmitted from foreign affiliates onto local firms. According to Lim (2001), the contagion effect can generate productivity and improve efficiency in local firms through spill-overs as local firms adapt technology that foreign affiliates use in the local market which increases development but also stimulates local employment. The presence of the foreign affiliate also forces local firms to become more efficient as the presence of the foreign affiliate increases the competitive pressures in the local market which leads to local firms abandoning inefficient working practices and adopting more efficient practices in particular in the use of existing technology and the allocation and distribution of their resources.

Additionally a particularly significant channel for spill-overs is through the linkages that are created between the foreign affiliate, local firms and customers. As foreign affiliates enter new markets, they create local networks with local firms for raw materials and other production needs which increases the interaction between the foreign affiliate and local firms and has far wider benefits for the local economy. Lall (1980) identifies that the foreign affiliate and local firm interaction leads to (i) foreign affiliates helping local firms to set up production facilities; (ii) forcing local suppliers to become more reliable through increasing product quality, delivery times as well as providing technical assistance to help improve the product or facilitate innovation; (iii) provide training and help in management and organisation; and (iv) helps access export markets by helping

suppliers find additional customers including sister affiliates and other independent external customers in other countries.[20]

2.6 Determinants of FDI

The issues related to the determinants of FDI are multidimensional, because different factors work behind the decision of foreign investors. For example, some investors seek large markets, some seek political stability and some seek a constant supply of natural resources. Thus the determinants of FDI might be multiple. The literature on the determinants of FDI is extensive and this is not reviewed in this section, however, it is assumed that the following variables are key drivers to FDI. Jensen (2003) argues that democracy and strengthening of political institutions is significantly correlated with strong FDI flows, which is also supported by Walsh and Yu (2010). Asiedu and Lien (2010) argue that the supply of natural resources facilitates positive FDI whilst Asiedu (2006) reiterates that market size, government policy, institutions and political stability also supports a countries ability to attract foreign investment. Baniak et al. (2002) argue in favour of a strong economy and legal environment as a facilitator of stable FDI; whilst Noorbakhsh et al. (2001) suggests that human capital and FDI flows are positively correlated.

2.7 How armed conflict affects domestic and international investments

As FDI is an important mechanism in the growth of developing countries, these countries need to create conditions which are conducive for creating a healthy investment climate for foreign investors; however, political instability can seriously impair any advantage it has over neighbouring countries in attracting foreign investors.

[20] There is an abundance of literature which supports the argument that technology transfer increases economic growth for developing countries (see Findlay 1978, Romer 1993 and Wang 1990). There is also contrasting literature which predicts that FDI is not as beneficial to the economic growth of developing countries (see Brecher and Diaz-Alejandro 1977, Mansfield and Romeo 1980 and Aitken and Harrison 1999).

The onset of armed conflict in particular has a far graver negative impact on a countries ability to attract FDI as it not only leads to deterring foreign investors and capital flight, but the escape of financial capital seriously impacts on domestic economic growth. So how does the initiation of armed conflict impact on economic growth through its impact on FDI?

According to neo-classical economic growth theory, it is the changes in the capital stock of an economy which impacts on economic growth. As capital stock is a crucial source of economic growth, it requires continued investment as it is vulnerable to depreciation and can become obsolete in the long term. When a country becomes involved in an armed conflict, the capital stock is affected in two particular ways. Firstly, the destructive nature of armed conflict reduces the capital stock as militaries and rebels target infrastructure including roads, bridges, ports and factories which are either destroyed or damaged; and secondly as internal armed conflict increases the rate of depreciation it also reduces much needed investment by accelerating investment loss through capital flight and the deterrence of new investment. Investments whether domestic or international are crucial for the maintenance and expansion of the existing stock and in order for it to be effective in stimulating economic growth, the rate of investment needed to maintain and expand the capital stock must outpace the speed of depreciation on the existing stock. As armed conflict accelerates the depletion of the capital stock, capital flight and the deterrence of future investment reduces the level and growth of the capital stock thus suggesting that a major way in which armed conflict affects the economy is through the dramatic reductions in investment.

This is useful in understanding how FDI fits within the mechanism of economic growth and how armed conflict lowers a countries growth potential but this does not explain how foreign investors react to the initiation of armed conflict. The best way to look at

this is through Collier's (1999) model which focuses on the responsive nature of capital to the changing economic environment. Collier distinguishes between fixed capital (land, labour and unskilled labour) and liquid capital and asserts that as liquid capital is mobile it is able to respond accordingly to the deteriorating economic environment compared to fixed capital. This can be furthered by Imai and Weinstein (2000) who explain that in the event of an armed conflict, holders of potentially liquid capital such as domestic and private investors make comparisons between the marginal rates of returns to their investments in the country relative to the acquisition of foreign assets. As armed conflict reduces the productivity of the economy and increases the rate of depreciation of the fixed assets, the rate of return on the investment is reduced which encourages domestic and foreign investors to engage in portfolio substitution and capital flight by shifting assets away from the domestic economy.

Furthermore, the negative effects of armed conflict also lead to potential foreign investors avoiding the economically and politically uncertain environment, instead opting to choose safer alternative destinations. Imai and Weinstein (2000) provide supporting evidence of portfolio substitution occurring in civil conflicts arguing that the responsive nature of private agents and the mobility of liquid capital lead to capital flight in conflict zones. The authors estimate that capital flight of private investment is four times larger than public investment with a strong correlation between the geographic spread of armed conflict and its effect on private investments. This is also supported by Collier et al. (2004) who finds civil conflict as a measure of risk leads to severe capital flight with a reduction in the incidence of civil conflict leading to the repatriation of the financial capital. And Fielding (2003), who argues that during Israel's intifada, significant transfer of capital including physical and financial took

place as Israel's domestic investors sought out safer destinations away from the home country.[21]

2.8 Theoretical evidence that armed conflict deters FDI

If domestic investors engage in portfolio substitution and capital flight, how do foreign investors react to armed conflict? There is an abundance of general literature on this relationship which argues that when choosing destinations for their FDI, MNCs choose destinations which yield the highest potential for profit and the least political risk. If MNCs opt to avoid political risk then it is inevitable that their rational response to armed conflict – a severe form of political risk – will be to avoid it at all costs and enter only when the political risk is at a minimum. There is a good deal of literature which investigates the effects of armed conflict on FDI with available literature often providing a mixture of results. The literature can be split between the political science and the international business disciplines with the studies in political science focusing on armed conflict, and the international business literature investigating political stability as a determinant of FDI. The two different disciplines using econometric analysis yield contrasting results with the political science studies arguing unanimously that armed conflict has a negative effect on FDI, whilst the business literature provides a mixture of different results.

Earlier studies cited in the international business literature conclude that empirical evidence does not clarify whether political stability affects FDI choices (see Kobrin 1979). Later studies, however, are more definitive. Schneider and Rey (1985) argue that the distribution of FDI depends on economic and political determinants where emergence of political unrest and the threat of foreign asset nationalisation presents a

[21] There is an abundance of literature which investigates the effect of political instability on capital flight. As this thesis is concerned with the effects on FDI, a detailed review is not provided. For more on capital flight see Alesina and Tabellini (1988) Mikkelsen (1991), Le and Zak (2006), and Davies (2010).

risk which is unattractive to foreign investors compared to political stability and a guarantee of property rights (p.161). Woodward and Rolfe (1993) support this line of argument and claim that the probability of a country being selected as an investment destination increases with political stability which is also supported by Loree and Guisinger (1995) who find that political stability is an investment incentive for US direct investment abroad. However, this is disputed by Olibe and Crumbley (1997) who do not find any evidence that this is consistent with US MNCs investing in OPEC countries and in a later study by Sethi et al. (2003) confirm that political stability does not influence US FDI flows. The inconsistency in these results can be explained by the unit of analysis employed by the authors who use an index of political instability which incorporates all forms of political activities such as demonstrations, strikes, armed conflicts and terrorist attacks. Although these activities alter the perceived notion of stability, the impact leveraged from local demonstrations on FDI is not as severe compared to the more severe activities such as armed conflict which has more drastic consequences for foreign investors. The ambiguity in the political stability index thus could help explain why the empirical evidence in the business literature is inconclusive.

If we isolate political instability to only include armed conflict, the results become more definitive and less ambiguous. Remaining with the international business literature, three notable studies which use armed conflict as a measure of political instability illustrate the potency of its effect on FDI. Nigh (1985) provides a good insight on the impact of severe political events on US manufacturing FDI (MFDI). Analysing US MFDI in 24 countries over a 21 year period, the author finds that intrastate and interstate conflicts negatively affect US MFDI. Separating his sample between industrialised and less industrialised countries, the author finds that the extent to which the different conflicts affect US MFDI depends on the level of national development,

with intrastate conflicts in developing countries affecting US MFDI but the same conflicts in industrialised countries having no impact. In finding an explanation to support his results, the author reasons that foreign investors are more concerned with political events in developing countries as it promotes instability and poses a greater threat to their financial interests compared to industrialised countries. Because the level of development in these countries is higher, political events in industrialised countries is not perceived as destabilising the business environment and therefore does not alter MNCs financial commitments to the host country.

Globerman and Shapiro (2003) contribute to the existing literature by arguing that a key determinant of US FDI is governance infrastructure which includes political violence. The authors controlling for economic and social development as well as currency fluctuations and proximity to the US market find that an index of political instability including armed conflict, social unrest and terrorist threats does not influence destination choices of US foreign investors but only influences the amount that is to be invested. In addition, this is partly supported by Li (2006). Working towards finding a more convincing set of results within the business discipline, the author attempts to disentangle the puzzle by focusing on the rational expectations of foreign investors and discerning political instability by only concentrating on civil and interstate conflict and transnational terrorism. The author using the same control variables as Globerman and Shapiro (2003) investigates how anticipated and unanticipated acts of violence impact on foreign investors decisions on the investment destination and the investment volume. The author concludes that civil conflict is found to have the worst effect on FDI compared to interstate conflict and transnational terrorism. Li (2006) also finds that a country which experiences civil and interstate conflict which investor fail to anticipate are rejected by foreign investors both in terms of it being chosen as an investment

destination and the amount of investment it receives whilst an anticipated civil and interstate conflict does not influence foreign investor behaviour in choosing it as an investment destination. For transnational terrorism, the results do not support the same assertion that acts of terrorism whether anticipated or unanticipated influence the behaviour of foreign investors.

Although the literature in the business discipline does provide mixed results, the results of the latter three studies which pit armed conflict as an index of political instability are consistent with the results offered within the political science literature. For instance, Busse and Hefeker (2007) analyse 83 developing countries during the period of 1984-2003, and amongst a range of economic, political and social variaFbles, investigate the impact of internal and external conflict on FDI. The results of the study are conclusive and suggest that MNCs care about internal and external conflict in the host country because of the effects it has on economic and political stability. The authors find that the incidence of violent conflict including civil conflict and cross border violence creates uncertainty which leads to increases in investment premiums for foreign investors. The reduction in FDI then has a catastrophic negative effect on economic growth due to the importance of capital flows for economic development which is consistent with the neo-classical economic theory on the importance of FDI to economic growth. These results are reinforced by an earlier study conducted by Pierpont and Krueger (2005) which supports the understanding that on a general level armed conflict lowers FDI. However, in this instance the authors find that although the presence of civil conflict reduces FDI flows per person, external conflict has a positive effect on FDI. The authors also go further and look at the lasting effects of armed conflict on the investment climate arguing that the negative effects on FDI continue long after the conflict ends. Although armed conflict lowers FDI, the perception of armed conflict can also have a lasting

effect. Asiedu (2002) analysis of FDI flows to Africa reveals that although armed conflict has historically lowered FDI to recipients, the continent as a whole suffers from its infamous association with political instability and armed conflict making the region contagious to foreign investors. The author argues that foreign investors perceive the continent of Africa as a risky investment destination with an armed conflict in one country often leading to neighbouring countries receiving lower levels of FDI.

In must also be emphasised that besides MNCs, adversity towards armed conflict is also stressed by states which prefer to avoid militarized disputes in order not to deter foreign investors (see Bussmann 2010). As the connection between poor economic growth and internal armed conflict is perfectly visible, there is also a connection between economic cooperation and the reduction in interstate conflicts. Working from the liberal claim that countries avoid armed conflict in order not to disrupt economically beneficial exchange (see Barbieri 2005), Bussmann finds that increased FDI between states reduces the incidence of armed conflict which coincides with Gartzke et al. (2001), and Gartzke and Li (2003) argue that the exposure to FDI is significantly related to a smaller likelihood of militarized disputes. This is also supported by Rosecrance and Thompson (2003), Souva and Prins (2006), and Polacheck et al. (2007) that economic interdependence through FDI improves international relations and reduces the likelihood that a country will initiate an armed conflict with a country where it has bilateral FDI flows. Fielding (2003) counters that in the event of significant capital flight of both physical and financial, the threat of renewed armed conflict increases.

2.9. The threats facing foreign investors from asset destruction to asset expropriation

i. Asset destruction

If the literature is correct in pointing out that political instability and armed conflict deters foreign investors, then how exactly does armed conflict affect the investment climate? The first and obvious threat facing foreign investors is from the breakdown in the rule of law which leads a worsening security environment. This increases the threats foreign investors face from **asset destruction** (see Mihalache 2010) and disruption to its operations, especially if the investment is both physical and human capital. As armed conflict leads to civilian fatalities and accelerates forced displacement as people flee, it also has an impact on production facilities and infrastructure, which is often targeted by warring actors. In addition, the breakdown in the rule of law also leads to asset theft and loss as machinery and other assets are often stolen.

ii. Increased transport and security costs

Secondly, armed conflict **increases transport and security costs** as it damages infrastructure leading to the disruption of important supply and delivery lines. This leads to firms suffering from losses incurred through not being able to get vital materials which are needed for production, or failing to get their products to market on time. If firms are producing perishable products, then increased costs are incurred in order to deliver the products to market on time as previous means of transport may no longer be reliable or available due to the deteriorating security situation (see Mihalache 2010). Therefore, alternative means of transport including the more costly air freight might have to be considered. Alternatively, firms operating in the natural resource sectors may incur additional costs in the protection of their personnel and the protection

in the transportation of their products because of the threats of extortion, hijacking or piracy. Therefore, in order to deliver their products to market, protect their personnel and secure their assets, foreign investors face increased premiums in transport and security logistics (see MIGA 2010).

iii. Nationalisation and expropriation of foreign assets

Thirdly, regulatory changes which leads to **nationalisation and expropriation of foreign assets** is considered to be one of the most extreme cases in which foreign investors incur not just temporary losses but total losses as this threat takes ownership of the investment away from the investors and in the control of the authoritative group. Although nationalisation of foreign assets has become rare (see Jensen 2003) regulatory changes which lead to expropriation are considered as most concerning to foreign investors when investing in conflict zones (see MIGA 2010).

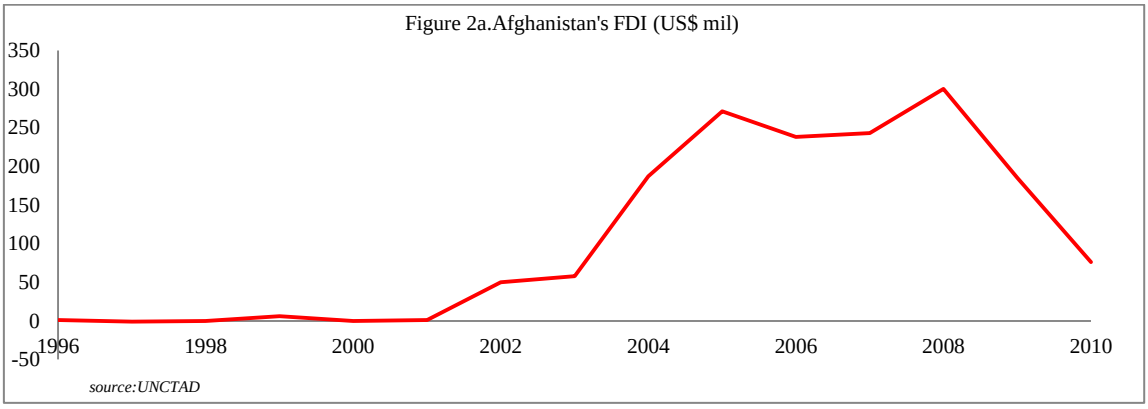
iv. Domestic demand shocks

And finally, armed conflict leads to **domestic demand shocks** which offer greater threats for sectors which serve the domestic markets and are concentrated in non-tradable goods such as commercial services including hotel, leisure and restaurants compared to sectors which are export orientated. As the destructiveness of armed conflict spreads and necessitates forced displacement, consumption becomes rationalised with demand for non-tradable commercial services falling whilst demand for consumer staples increasing. Therefore, foreign investments concentrated in the services sector see demand contracting.

2.10 Stylised empirical evidence of FDI into armed conflicts and conflict specific explanations

The culmination of the threats foreign investors face when considering conflict zones are sufficient to deter them away to alternative safer destinations. The international business and political science literatures are certain that political instability, and in particular, the most severe form of instability – armed conflict – leads to declining levels of FDI, as foreign investors are deterred by the destructive nature of armed conflict in particular by the threats outlined above. In most cases the overall levels of FDI do fluctuate during armed conflict but country specific data shows that they generally remain above zero, and although financial capital does escape, considerable levels of international capital continue to flow into conflict zones. For instance, looking at FDI trends for Afghanistan over a 14 year period in which it has been involved in several high-intensity armed conflicts shows that foreign investors have deviated from the expected behaviour of avoiding conflict zones and instead have seen it as an investment destination. Of particular interest is the trend in increased FDI beginning from 2001 which corresponds with the beginning of its interstate conflict with the US.

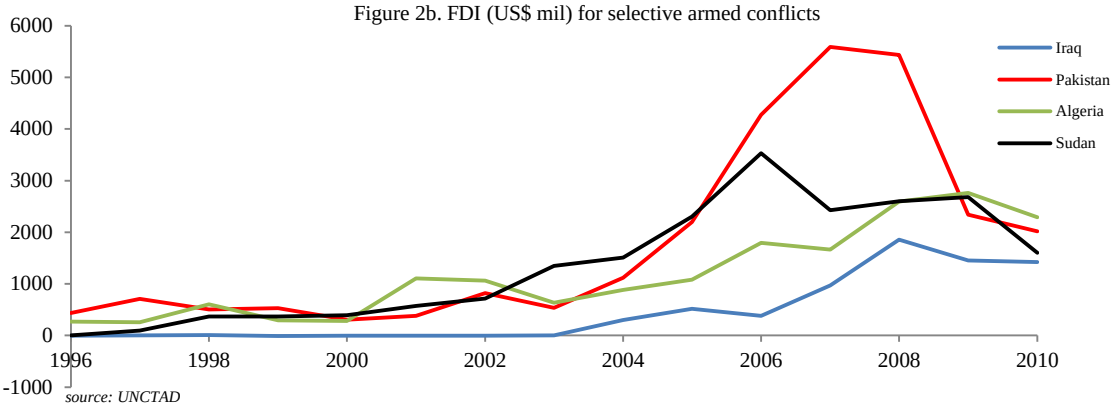
Figure 2a.Afghanistan's FDI (US$ mil)



Afghanistan is not an anomaly as country specific data shows that other countries have also been able to attract FDI whilst being involved in high-intensity armed conflict. The

graph below shows FDI trends for Algeria, Iraq, Pakistan and Sudan which were all involved in either an interstate or civil conflict. And similarly to Afghanistan all four have seen foreign investors continue to commit to investment projects.

Figure 2b. FDI (US$ mil) for selective armed conflicts



source: UNCTAD

There are very few explanations offered within the literature which helps to explains why foreign investors continue to choose conflict zones as investment destinations considering that the investment climate is inundated with both political and economic instability. The literature within the political science and international business disciplines suggest that in the presence of armed conflict, foreign investors intuitively avoid conflict zones as the threats emanating from such instability have a negative effect on the investment especially as the key determinants of FDI are often missing from uncertain investment climates. Therefore, if the literature is correct in pointing out the negative effects of armed conflict on FDI, then what explains the many examples which exist which show that countries involved in armed conflict continue to attract FDI?

As foreign investors commit to investment destinations based on perfect knowledge of the investment climate, it is best to begin our search for possible explanations into the complex reality of FDI inflows into conflict zones by looking at the strategic behaviour of foreign investors and whether certain factors within conflicts help mitigate some of

the threats that exist. Although it is perilous to generalise about the international private sector as a whole and the strategic behaviour of foreign investors should be viewed as being heterogeneous (Mihalache 2011), there are a number of variables within conflict zones which help to unravel this complex relationship. For instance, we should take for granted that the type of conflict and its severity will affect foreign investors differently with the more severe and widespread the conflict the greater the negative impact on FDI. Alternatively, if governments can take measures to contain the conflict away from investment intensive areas and provide sufficient protection to the investment and investors interests, then it is plausible to assume that FDI will continue to flow into conflict zones. These factors cumulatively contribute towards the thinking process of foreign investors but additional non-specific factors such as the distribution of FDI and investment strategies undertaken by foreign investors to minimise risk must also be considered.

i. Geographic impact of conflict

The most important factor in determining whether foreign investors will chose a conflict zone as an investment destination is based on the perceived geographic reach of the conflict and whether the government can prevent the spread of violence into commercial and urbanised areas. According to Berman (2000), foreign investors are prepared to commit to conflict zones providing that the conflict can be isolated and limited to the coastal or rural areas with significant distance between the conflict and the location of the investment acting as a safety buffer.[22] Foreign investors prefer to locate their operations to urban areas which provide a sense of security often missing from war

[22] Berman's article is taken from the results of the Political and Economic Link Consulting (PELC) survey which analysed the decision making processes of 25 multinational corporations (MNCs) operating in regions of armed conflict around the globe, including Algeria, Angola, Azerbaijan, Colombia, Congo, Georgia, Kazakhstan, Indonesia, Northern Ireland, and Sri Lanka. The MNCs taking part in the survey operated in a wide range of industries including natural resources, infrastructure, manufacturing, services and retail. The results of the interviews were enhanced by the views of a dozen experts in related topics such as political risk insurance, sovereign debt rating and international investment promotion (see Berman 200, p.28).

ridden rural areas as government forces concentrate their security to more populated areas. And considering that urban areas offer significant market reach to foreign investors, these areas also become investment intensive which require additional security in order to prevent any disruptions to the operations of foreign investors. Therefore, the containment of the conflict to the coastal and rural areas outside the reach of the commercial and urban areas is a key consideration for foreign investors when assessing the risks of armed conflict. This argument can be used to [*partially*] explain why FDI continued to flow into Algeria during its civil conflict as the security forces were able to isolate the violence to the coastal areas of the Atlas Mountains and away from the commercial and investment heavy southern and southern western urbanised areas.[23]

It is possible that not all conflicts can be contained to the coastal or rural areas especially in conflicts which are fought over territorial claims and where the armed opposition have significant military capabilities to take effective control of government territory. As armed conflict spills-over from coastal and rural areas into more commercial and urbanised areas, the risk to the investment increases as the threats from armed conflict has a direct impact on the investment. In this likelihood, governments' ability to respond to this spill-over determines whether existing foreign investors flee the conflict zone and whether new investors can be attracted.

Foreign investors need to have confidence in the government's ability to respond effectively to dynamical changes in the conflict and if the government is ineffective or too slow then significant confidence is lost which leads to a weakening of the investment climate. Additionally, if the conflict starts to increase in intensity and

[23] This spatial pattern of armed conflict could also be used to explain why Colombia was still able to attract FDI during its civil conflict where at its most potent the armed opposition were able to control 40% of the territory. As the government forces were able to contain the violence to the non-commercial and non-urban areas.

becomes more widespread and the government is able to respond swiftly to such changes, then foreign investors have significant confidence in the government's ability to manage the conflict effectively. This therefore increases the government's ability to attract FDI as foreign investors are confident that the government has the ability to manage the conflict and any changes in its dynamics.[24]

ii. Severity of armed conflict

The severity of armed conflict is also an important factor in determining whether foreign investors will take on the risks emanating from conflict zones. Different conflicts present different risks which are tolerated differently by foreign investors with the more severe conflicts such as those fought over territorial claims presenting greater risks compared to infrequent terror attacks. For example, territorial conflicts where effective control of territory is in the hands of the opposition has a negative impact on foreign investors as they are unwilling to sustain or initiate operations as the level of risks is far too great to take (see Berman 2000). However, as an exception to this rule, FDI can continue to flow into territorial conflicts if foreign investors have the resources to employ or acquire military capabilities to protect their investments, however, this is exceptional to only certain sectors of the economy including the more lucrative natural resource sectors (see Renner 2002, Le Billon 2004, and Holden and Jacobson 2007). Moreover, incursional conflicts where armed groups frequently engage in attacks on commercial areas outside of their control are far more tolerated by foreign investors as the government maintains effective control of key areas and the opposition have limited capabilities to take and hold significant territory. In this type of conflict, foreign

[24] For example, when the Shining Path guerrilla movement threatened the operations of foreign owned firms in Peru, the quick response from the Peruvian army in defending the mines restored the confidence of current and potential investors (see Berman 2000, p. 29).

investors can take additional safety precautions by employing private security contractors to protect their investments, interests and assets.

And finally, acts of terrorism are widely tolerated by foreign investors providing that they are infrequent and do not do lasting damage to commercial infrastructure or disrupt supply lines including firms which provide domestic logistical services to the operations of foreign investors. Terrorism has the capacity to deter foreign investors especially if foreign investors are joint targets with the government although this is only limited to groups which have strong ideological foundations such as the Taliban in Afghanistan and Al-Qaeda in Iraq which target foreigners and foreign businesses. The long term impact of terrorism is destabilising but its effect on FDI is small as shown in Tel-Aviv during the height of the Palestinian and Israeli conflict and in Northern Ireland where the frequent acts of terrorism did not have long term negative effects on FDI.

iii. Nature of the government

If foreign investors can tolerate the intensity of the conflict and its severity, then significant consideration is given to the investment climate provided by the government. As one of the threats emanating from armed conflict is the sudden change in government policy towards foreign investors including expropriation and nationalisation of the investment and its assets (see MIGA 2010), foreign investors have to be confident that the investment climate is positive and will remain positive despite the conflict. This positive investment climate could off-set some of the risks associated with armed conflict as it demonstrates that the government is interested in retaining its current investors as well as continuing to attract new investors. For example, some of the FDI flow during Northern Ireland's troubles is credited to the business friendly

environment which attracted foreign investors despite the troubles between Protestants and Catholics (see Berman 2000, p30).

In addition, governments can exacerbate investment loss through its handling of armed conflict in regards to its curbing of human rights. As greater spotlight is given to human rights abuses in conflict zones, foreign investors are heavily scrutinised when choosing investment destinations in fragile states and places of armed conflict (see Spar 1998 and 1999) with the expectation that doing business with governments complicit in human rights abuses should be avoided. The 'audience costs' (see Blanton and Blanton 2007, p. 145) that foreign investors incur when doing business in places where human rights are violated can damage a foreign investors image and reputation as well as their stock value[25] and although foreign investors may feel that conflict zones are investable destinations, the actions of governments in the violation of human rights could act as a deterrence. Therefore, countries involved in armed conflict can increase their FDI attractiveness by respecting human rights and thus reducing the 'audience costs' to foreign investors.

As human right violations can deter FDI, government action in terms of making information available to foreign investors on the development of the conflict and their actions towards it, as well as government policies which could affect the operations of businesses, are also considered integral towards attracting new FDI. As part of FDI strategies, foreign investors rely upon accessible information so that they can assess the risks presented by armed conflict as well as plan their long term operations. Information on the development of the conflict and the government's response to it is a necessity as any changes in conflict dynamics or government action could have long term

[25] For instance high profile examples of companies which have incurred costs due to complicity in human rights violations include Nike in Indonesia, Unocol in Myanmar and Texaco in Ecuador (see Ottaway 2001). Additionally evidence which shows that companies are responsive to this "audience costs" are the divestment of Apple and Kodak from Myanmar after the state of Massachusetts sought to sanction the country for its human rights violations (see Economist 2000b).

implications to the investment climate. If governments make information accessible, then foreign investors perceive this action as contributing towards a healthy investment climate as it installs confidence that the government is acting in the interest of businesses by keeping them informed of developments. However, if governments' become secretive and limit access to information, then this is viewed negatively by existing investors who assess such action as contributing to a negative investment climate, whilst potential investors view such secrecy as an action of a government which is trying to hide the seriousness of the conflict.

Additionally, if governments start to implement domestic policies to control the conflict such as night time curfews then this is seen as hindering the operations and productivity of businesses. Although such policies are seen as security measures to prevent violence from spreading into urban and commercial areas, it can affect business productivity by restricting their night time operations. According to Berman (2000) during the Sri Lankan civil conflict, the government implemented policies which were seen to be unfriendly towards businesses which included night time curfews which restricted their night time operations.

iv. Nature of the opposition

In assessing the risks of operating in conflict zones, foreign investors have to calculate whether they can continue to operate if the armed opposition is able to take effective control of commercial areas or areas where the operations of foreign investors are located. For instance, some armed groups are irredentist in nature where their main aim is to take effective control of territory away from the government. In such conflicts foreign investors have to assess whether they can continue to operate if there are shifts in territorial control and whether they will face additional security risks if the armed

opposition is able to take control of territory in which the investment is located. This is most concerning in conflicts where the opposition is irredentist and has a strong ideological base which is hostile towards foreigners, foreign affiliates and the private ownership of property as it suggests that foreign investors will relocate to safer destinations whilst potential investors will be deterred by the shifts in territorial control and the hostility of the armed oppositions towards the presence of foreign investors. For instance, groups such as the Taliban in Afghanistan and Al-Qaeda insurgents in Iraq possess an ideology which is considered a danger to foreign investors from the western hemisphere as the ideology of these groups calls for attacks on all western interests; economic and political. And during the apartheid era, the African National Congress (ANC) was perceived as being unfriendly to foreign businesses as it espoused a socialist agenda calling for wide scale nationalisation of private property and national industry (see Berman 2000).

Some levels of toleration are evident in irredentist conflicts providing that the armed opposition is not hostile towards foreign investors. Such examples of FDI flow exists in armed conflicts where the armed opposition is able to take effective control of government territory without affecting the investment climate. For example, in the on-going conflict between the semi-independent state of Abkhazia and Georgia, foreign investors have continued to operate as normal as the armed opposition have indicated no hostility towards foreigners, foreign businesses or the private ownership of property. And in the Northern Ireland conflict the rights of foreign businesses were respected whether they operated in areas under the control of unionist or nationalist forces (see Berman 2000, p. 30).

One of the main consequences of armed conflict is the destruction it causes to key utilities such as transport and telecommunications terminals but also the disruption to

labour markets through either killing or forced migration. Foreign investors when determining investment destinations need to assess whether key infrastructure is in place including access to raw material and adequate labour is available for production. Attacks on utilities implies an unreliable investment infrastructure but shortages of adequate labour though human capital flight (see Gupta, Clements, Bhattacharya and Chkravarti 2004) and forced migration is a strong indicator of likely future disruptions to production as well as a stagnating market especially if foreign investors are providing goods and services to local markets. If countries involved in armed conflict can prevent disruption to telecommunications and transport terminals but also prevent labour shortages, then it can remove some of the deterrence often inflicting foreign investors.

2.11 Distribution of FDI and sector level perspectives

Moving away from country specific and conflict specific factors, another set of possible explanations lie in the nature of the foreign investor and the nature of the sector which attracts FDI. Political risks is seen as the biggest obstacle for foreign investors when selecting investment destinations but as foreign investors are heterogeneous bodies, their perceptions of risk differ based on the nature of their own characteristic and the nature of the sector they operate in. For instance, according to MIGA (2010), the location, the size, and the volume of the investment are key determinants which could help explain how risk perceptions amongst foreign investors are viewed. MIGA (2010) suggests that south based foreign investors are more receptive to political risks in particular to conflict zones than north based investors with firm size also indicating that smaller sized investors are more sensitive to political risks because they suffer greater losses in conflict zones.[26] If foreign investors represent smaller sized firms, their ability

[26] The MIGA study is based on responses of foreign investors involved in conflict zones (the MIGA-EIU CAF Investors Survey). These findings complement the findings of the MIGA-EIU Political Risk Survey 2010. The survey involved over 45,000 Greenfield

to safeguard the investment or make allowances for losses are significantly fewer compared to larger investors who have greater resources to safeguard their investments and assets through increasing their security by employing or acquiring military capabilities.

The size of the investment project is also a key factor in conflict zones. Smaller investment projects are more frequent because of the fewer resources that are required which carry fewer risks but also as the size of their operations are small they are also less noticeable. Larger investment projects are alternatively less frequent because of the greater resources they require but also because large investment projects tend to have larger operations, their vulnerability towards asset destruction increases.

From a sector level perspective, foreign investors are able to tolerate significant risk depending on the sector they operate in as certain sectors possess characteristics which have significant influence on foreign investors' willingness to enter or remain in a conflict zone (see Berman 2000). Some sectors possess characteristics which make them durable to armed conflict whilst others are more sensitive to the deteriorating political and economic environment. The characteristics of the sector helps us understand why foreign investors continue to select conflict zones as investment destinations as the distribution of FDI is based on the advantages that some sectors possess with some sectors better able to deal with the risks emanating from armed conflict. For instance, some sectors require physical assets which are vulnerable to asset destruction, while other sectors reduce their exposure to this risk by shifting to more intangible assets. Some sectors which serve the domestic market are more prone to domestic demand shocks when markets contract due to forced migration or deaths while other sectors are able to shift their focus to international markets and through exports are able to reduce

investment projects with over 1,000 involved in conflict zones. For previous surveys on how business executives view political risks from a sector perspectives see Bass et al. (1977) and Porcano (1993).

their exposure to stagnating domestic markets. And finally, some sectors require local supply chains for inputs or adequate labour which are vulnerable to spill-over effects of armed conflict if governments are unable to contain the conflict away from commercial and urbanised areas, whilst others are able to reduce their reliance to local suppliers by shifting their location to be closer to alternative suppliers in more stable locations. Therefore, depending on the characteristics of the sector and the advantages it possesses, foreign investors can mitigate their investment risks by operating in sectors which are less sensitive to armed conflict or in sectors where the level of reward is worth the level of risk undertaken.

i. Natural resource sector

Intuitively, sectors which require physical assets and are capital intensive should be less attractive to foreign investors because they are vulnerable to asset destruction and incur greater losses if the investment is expropriated, but FDI trends suggest that significant levels of investment often find their way into the primary sectors which require intense physical and financial assets. Investments into infrastructure and extraction sectors are common with the natural resource sectors including gas and oil attracting significant investment because of the supply potential it offers which significantly outweighs the risks of armed conflict but also because of its insensitivity towards domestic demand shocks. As the nature of the product is to serve the international market, it has limited links to the domestic economy; therefore, any contractions in domestic demand can be offset by increasing export to international markets. As natural resources are also limited to frontier regions where it has no location substitutability, its scarcity and commodity value attracts foreign investors who attempt to benefit from 'first-mover' advantage (see Patey 2006) in securing potential locations which may offer significant untapped resources before their competitors move in. Therefore, securing unexploited

natural resource has a strategic importance to the commercial enterprise of foreign investors operating in this sector.

The competitive nature of securing unexploited natural resources suggests that in conflict zones it is 'junior' companies which are willing to take the risks associated with armed conflict in the hope of making major finds before larger companies come in. As these sectors require extensive capital, larger companies are prepared to wait until it is safer especially as the time horizon between the exploration and the project coming into production may take many years. The major threats that investors face in these sectors are from asset destruction and the threats facing their personnel due to the intensive capital requirement, but threats also emerge from changes to the investment climate through sudden policy changes including nationalisation and expropriation of the investment. In regards to asset destruction and threats facing its personnel, the investor can reduce its vulnerability to asset destruction by allocating further resources in the protection of its assets including its workers. This is helped by the prime location of the resource which is often located in remote areas which are often militarized by security forces provided by the host government (see Renner 2002, Le Billon 2004, and Holden and Jacobson 2007). The protection of the investment is of strategic importance for both the investor and in most cases the host government, as oil revenue helps finance government's military expenditure (see Human Rights Watch 2003). Although the immediate investment location can be secured, the investment is not completely sealed away from asset destruction as it is reliant on transport links to take the product from the extraction point to the intended market. This is often done through oil and gas pipelines which are vulnerable to frequent attacks especially if they run through remote areas outside of government control - Therefore, although the initial investment at the

extraction point may be protectable, it is impossible to provide full security in the operations, extraction and transportation of the product.

ii. Engineering sector

Engineering projects are also capital intensive and prone to asset destruction and similar to the natural resource sectors also offer foreign investors lucrative investment opportunities. Reconstruction projects are hotly contested as this involves companies competing for aid-sponsored reconstruction contracts such as rebuilding roads and reconnecting power and water supplies. These projects which are often financed by bilateral or multilateral aid often arrive before the end of an armed conflict as they are an essential element in bringing peace and stabilising local societies. These projects are also seen as a vital part in attracting foreign investors into other commercial sectors as without basic infrastructure nothing else can happen (see Bray 2005). Engineering projects in reconstruction are financed through aid programmes which guarantee payment to foreign investors thus reducing its exposure to domestic demand shocks, and as these projects are located in major cities, the presence of government security reduces its vulnerability to asset destruction, although they are still prone to guerrilla attacks or targeted bombings as witnessed in engineering projects in Afghanistan and Iraq. However, the threats foreign investors face in this sector also varies according to the location of the investment with investments which are located further away from major cities being more prone to losses due to reduced government security outside of the major cities. Commercial engineering projects including building hotels, homes and restaurants carry greater risks because they serve domestic markets and therefore are more sensitive to domestic demand shocks. These projects do not have a guaranteed revenue stream although hotels often find international clients including diplomats, Non-Government Organisation (NGOs), international media and personnel from

external militaries if there has been an intervention frequenting as clients. These projects are also prone to asset destruction as seen in the bombing of the Marriot hotel in Pakistan in 2009, although the use of private security contractors eases some of the risks involved.

iii. Services sector

The service sectors are also attractive to foreign investors, however, unlike the primary sectors which are capital intensive and thus vulnerable to asset destruction, the service sector requires less physical assets and relies intensively on intangible assets instead. The need for non-physical assets reduces the losses it may face from asset destruction but because of the necessity of needing skilled labour it is vulnerable to forced displacement especially if key workers have to flee conflict zones. The greatest Investment risk arises from domestic demand shocks as the nature of these sectors is to serve the domestic market (see Mihalache 2010). These sectors include financial, software and information technology service providers and as they are high-tech industries they tend to be more deterred than lower-tech industries such as consumer staples or consumer durables. It would seem that financial services would attract significant foreign investments, but MIGA (2010) suggests that initially this investment is minimal as a proportion of total investments in the services sector with the bulk of the investment going into services in infrastructure projects. International banks do anticipate opportunities in conflict zones but this is premised on the presence of international bodies and clients such as the presence of diplomats, Non-Government Organisations (NGOs) and International Organisations (IOs) (see Bray 2005) which suggests that the investment decision is based on external intervention (humanitarian and political) including military and other foreign investors in the conflict.

The prospects for domestic retail banking remains limited until after the conflict has ended when international banks start providing increased services to domestic clients. As international banks arrive later into the conflict they only form a small part of the financial infrastructure with other agencies including micro-credit institutions coming earlier. Security is a major factor for international banks in conflict zones as they are frequently attacked by rebels, insurgents or terrorist groups and often victims of criminal behaviour. Additionally, International banks are well versed in the security measures needed to reduce the risks in conflict zones; however, this is exacerbated if the home government of the bank has influenced the armed conflict or unfavourably intervened militarily. Therefore, international banks could suffer further attacks if they are seen as representing the interests of their home governments (MIGA 2010).

iv. Telecommunications sector

The telecommunications sector remains attractive even in the presence of armed conflict. Foreign investors in these sectors have shown a pattern of spectacular entrepreneurial initiative in setting up operations during armed conflict – and their success is often a precedent for international investors as they demonstrate that commercial success is possible. Telecommunication networks are part of the basic infrastructure so without functioning communications networks it is difficult to attract investments in other areas as their services make it possible for other companies to operate. In similar nature to the natural resource sectors which require intensive capital and having huge sunk costs, the costs incurred by foreign investors in the telecommunications sector are often one-off with further costs coming out of the payback which is immediate. Unlike the natural resource sectors which may not receive any returns on the investment due to the lengthy time horizons between extraction and production, investments in the telecommunications sector often see immediate returns as revenue starts the moment the

first call is made. As the onset of internal armed conflict is connected with underdevelopment and poverty in developing countries, these countries offer lucrative markets as they are often unsaturated with only a few service providers.

The threats to foreign investors often stem from asset destruction because of the need for phone masts but their exposure to such threats are limited due the necessity of communications during armed conflict. Headquarters are often located in either neighbouring countries or in major cities which are relatively well protected by government troops or local security contractors. Telecommunications should be adverse to domestic demand shocks but because of the cost of making phone calls are charged at a minimum and the need for communication during armed conflict is necessitated by the value placed on accessing news and information in an uncertain environment, investments have lower sensitivity to contractions in the market. And with the unreliability of fixed-line networks during armed conflict and the low cellular penetration in developing countries, the telecommunications sector offers foreign investors an attractive growth potential (see Konkel and Heeks 2009).[27]

2.12 Foreign investment strategy

The four sectors of the economy possess various characteristics which suggest that foreign investors face different risks when investing in conflict zones and if foreign investors can prevent asset destruction through increasing security and can mitigate the losses from domestic demand shocks by substituting domestic markets for international markets, then the losses they face during armed conflict can be reduced. All the sectors outlined above have various characteristics which are vulnerable to either all of, or some of, the threats emanating from armed conflict with only the natural resource sectors able

[27] According to the World Bank, mobile phone companies are quick to set up operations in conflict and post-conflict countries to the extent that their presence is an indicator of private sector recovery (see Schwartz et al 2004, p. 13).

to protect the investment from asset destruction and domestic demand shocks. It would be intuitive to believe that any investment which requires intense capital in financial, human and fixed would be deterred from conflict zones because the cumulative threats from armed conflict also including expropriation and nationalisation of the investment will weigh too heavy a risk for the potential rewards on offer. For instance, the natural resource sectors require intense capital, offer no substitution in the location and have long term payback horizons whereby increasing the sectors sensitivity to armed conflict yet it still receives the majority of FDI during armed conflict. But the unique characteristics that it possesses such as its scarce availability, its prime location, its export worth and the militarization of the location because of the host government's dependency on natural resource revenue offers sufficient advantages which to some extent alleviate the risks involved. These 'shielded inputs' (MIGA 2010, P.45) makes the sector an anomaly compared to the non-resource sectors which are devoid of the key advantages that could make the investment into these sectors durable to the threats of armed conflict. The sector level perspectives for the engineering, manufacturing and telecommunications sector does provide a mixture of possible explanations but it lacks conviction and consistency as these sectors require similar inputs to the non-resource sectors and possess advantages which make them as lucrative in their own right but they also suffer from the obvious threats emanating from armed conflict. This vulnerability but also the distribution of investment in these sectors therefore leads to the possibility of looking away from sector level perspectives and worth considering external influences in the distribution of FDI in conflict zones.

i. Investment strategy

Another set of factors which could help explain the distribution of FDI is the investment structure foreign investors select to reduce their risks when operating in conflict zones.

By selecting an appropriate investment strategy, foreign investors can enhance their confidence and avoid potential losses and, perhaps more significantly, improve their ability to raise financing for the project (see Berman 2000). Foreign investors often begin their business engagements in conflict zones by adopting a low risk strategy whereby early engagement is often through exports and imports, eventually progressing to licensing agreements or contract manufacturing before any equity investment is made. As the low risk strategy proves successful and sufficient confidence is built in the high risk conflict zone, some low level equity investment such as joint ventures or small wholly-owned investment is made which in turn generates further investment. This type of strategy allows foreign investors to manage their investments on par with the conflict as it begins with low levels of engagement which eventually increases once foreign investors feel confident that such higher levels of investment can be managed against the risks of armed conflict.

ii. Political risk insurance

Another reason which could help explain why conflict zones continue to attract FDI is the political risk insurance (PRI) which foreign investors take out to limit the risks of investing in conflict zones. PRI safeguards foreign investments in politically instable countries from losses incurred through armed conflict and politically motivated violence but also from expropriation and nationalisation of the investment with additional premiums covering foreign investments in conflict zones. As well as PRI, foreign investors also supplement their insurance by taking out additional guarantees with host-country governments which reduces their vulnerability to losses. For instance, foreign investors in Northern Ireland took up "terrorist top-up" which was offered by the UK government to supplement the PRI schemes (see Berman 2000, p. 32).

iii. Payback and risk reduction

In order to minimise the risks from armed conflict, foreign investors will also structure the investment payback period so that the initial capital investment could be recouped during a stable period in the conflict. Although foreign investors attempt to achieve profits from the investment, recouping the initial outlay helps foreign investors to reduce their net losses if the investment climate deteriorates to the point where foreign investors can no longer operate because of the heightened non-commercial risks. If the threats from armed conflict lead to expropriation or nationalisation of the investment, then the recouping of the initial capital outlay reduces the overall losses the investor faces.

As well as structuring the payback period, foreign investors also structure payments so that all funds from the investment remain offshore and beyond the reach of the host governments and the insurgent government if it is able to take effective control of the country. By depositing payments offshore, foreign investors can safeguard against possible repossession of all transactions especially if the authority is stretched for resources because of the armed conflict. Additionally, this method of safeguarding funds is limited to industries which do not have significant interaction with the domestic economy including natural resource extraction which is predominately export orientated where export sales can bypass the host country and instead be deposited in safer countries. Although this is a good risk reducing strategy for foreign investors, it is not applicable to all sectors of the economy especially to investments which derive most of their revenue from the domestic economy, unless there are no controls to curb capital flight.

iv. Participation with multilaterals

And finally, another factor which helps towards building an explanation on the distribution of FDI into conflict zones is how foreign investors minimise their risks by participating in multilateral development organisations which they believe greatly reduces the risk to their investments. Foreign investors believe that participation with multilaterals by either securing funding for the investment, taking out a loan or seeking guarantees on host country government performance safeguards their investment interests in instable investment environments (see Berman 2000). The importance that foreign investors attach to multilateral stems from the strong influence multilaterals have over host country governments through their financing of development projects which comes from extensive loans, grants and other financial programmes. This linkage gives multilateral significant influence over host country governments which gives confidence to foreign investors that in the event that political forces endanger their investment, the multilateral will lend weight to the investors in their negotiations with political forces.

2.13 Research Variable: The role of external military intervention in attracting FDI

Foreign investors are not deterred by armed conflict. The expected path of behaviour that the international business and political science literatures claim that foreign investors take is no longer apparent as country specific data shows that foreign investors continue to select conflict zones as investment destinations. Although the threats of armed conflict are legitimate and do contribute towards increased costs in terms of additional security and further losses through domestic demand shocks and asset destruction, there is ample evidence on show that these threats do not completely render

conflict zones devoid of FDI. The previous section has attempted to bring to the mix possible explanations why foreign investors are deviating from the expected theoretical path by presuming that key characteristics of the sectors increase the likelihood that it can attract FDI. These characteristics which stem from investment volume, to the size of the MNC as well as capital formation required and market orientation all play an important role in either increasing or decreasing the sectors chance of attracting FDI. But as the previous section has also shown that despite these characteristics the non-resource sectors are not durable to armed conflict and sector level perspectives are unable to provide a convincing explanation on the distribution of FDI into the non-resource sector.

This thesis proposes that consideration must extend beyond sector level perspectives and focus on external variables which could be influential determinants of FDI during armed conflict. One of these variables is the presence of an external military intervention during armed conflict and its impact on foreign investors' perception to risks. This thesis promotes the idea that an external military intervention assists foreign investors in their decision making process as the intervention gives out 'positive signalling' through replacing the absence of security and mitigating some of the risks foreign investors would otherwise face without the intervention. Foreign investors appreciate the external military intervention as its contribution improves the investment climate by providing stability and authority in an incendiary political and economic environment. Its presence, therefore repairs investors' confidence by restoring the rule of law, assisting in the reconstruction of economic and political institutions, reducing the level of violence and working towards a lasting end to the armed conflict. As conflict zones are viewed as attractive investment destinations during peace, the incidence of armed conflict reduces its attractive worth to foreign investors as it

increases the commercial and non-commercial risks; however, the presence of an external military intervention mitigates the risks involved and restores the attractiveness of the destination.

Although the literature on external military intervention in conflict zones is a widely studied area, its influence on FDI has been given limited attention. Most emphasis has been given to its role in peace-building (see Fisher 1994, Rosas 1994, and Kegley and Hermann 1997), political regimes transitions (see Aidt and Albornoz 2009), the economic motives of interventions (see Rosenau 1969, Pearson 1974, Carment and Rowlands 1998, and Carpino 2006), or its promotion of post-conflict economic growth (see Pickering and Kisangani 2006). However, very little attention has been given to its importance to FDI during armed conflict as most studies emphasise post-conflict FDI as a means to prevent renewed armed conflict because of the inextricable link between the health of the economy and the durability of peace.

The literature linking the presence of an external military intervention on post-conflict FDI does give some clues which could be extrapolated to help explain FDI flows during armed conflict. Toal (2010) links the presence of an external military intervention to positive inflows in FDI within the first three years once the conflict has ended. Ahern (2005) finds that the presence of UN peacekeepers stabilises or improves states ability to attract FDI with positive inflows in FDI recorded in the post-conflict recovery stage. And Lo and Kucik (2011) support Ahern's assertions by suggesting that positive FDI inflows are unique to UN peacekeeping missions which are multidimensional. This could be explained by the international consensus which often accompanies UN peacekeeping missions such as long term peace-building through the reconstruction of economic and political institutions and monitoring and enforcing peace settlements between antagonists. These measures are conducive to FDI as it reduces the amount of

political risks involved by working towards long term stability as well as reducing the likelihood of renewed armed conflict.

Looking beyond UN peacekeeping missions, Perez (2003) contends that US troop deployment in areas of crisis also leads to positive FDI flows providing that the intervention has a positive outcome which resolves the crisis in the intervened country. This is premised on the idea that the outcome is perceived appreciably by foreign investors who view the intervention as not just bringing stability but also improving the investment climate; however, returning a country to civilian government is also seen as a positive determinant of FDI.[28] As military interventions come in different sizes it is expected that larger interventions over smaller interventions and responses to crisis rather than pre-emptive actions also creates better conditions for FDI.

It is interesting that although these studies find a positive link between the presence of an external military intervention and post-conflict FDI, no attempt has been made to assess the origin of the investment or who dominates post-conflict FDI especially as some of the literature on the motivations for external military interventions do claim that economic interests are at play (see Rosenau 1969 Pearson 1974, Carment and Rowlands 1998, and Carpino 2006). This should suggest that states that partake in military interventions dominate in the post-conflict investment climate through the 'following the flag' factor (see Biglaiser and DeRouen 2007, p. 836) as foreign investors follow the external military intervention into the conflict zone. The finance literature suggests that as a determinant of FDI there is a 'near-home bias' (see Levis et al. 2010, p.3) where foreign investors choose investment destinations in close proximity to their home countries as it gives them transactions advantages over MNCs which are located further away. The near-home bias also claims that foreign investors prefer to

[28] For instance, the author cites the example of the Yugoslav conflict and states that the military campaign did not significantly affect FDI, however the proceeding Dayton Accords which put an end to the armed conflict in Bosnia affected FDI positively.

invest in neighbouring countries where there is an element of social, cultural and institutional familiarity (see French and Poterba 1991 and Huberman 2001). In the context of armed conflict, the near-home bias could be used to explain the conflict – FDI nexus as one of the reasons could be premised on the sharing of cultural, religious and social ties which permits foreign investors in neighbouring countries to view the risks differently and feel less threatened then investors located further away. Investors who share similar culture, religion or social benefits may not view armed conflict as a deterrent and may find it easier to invest in neighbouring countries affected by armed conflict as their similar culture, religion and social make-up may actually reduce the obvious threats which often face foreign investors. Therefore, it could be assumed that as distance to armed conflict deters foreign investors because the greater distance between the investors and the host represents greater cultural, religious and social differences – the distribution of FDI could be explained by the near-home bias as investor closer to home account for total FDI but also account for investments into sectors which are theoretically vulnerable to armed conflict.

Alternatively if external military interventions are motivated by economic interests then there should be a 'following the flag' factor (see Biglaiser and DeRouen 2007, p. 836) – where troop deployment and origin of FDI are positively correlated. Although external military intervention is not an accepted practice to protect or promote FDI (see Finnemore 2003), the presence of an external military intervention does placate the dangers facing foreign investors when locating to a conflict zone as the intervention offers security which is desired by foreign investors – therefore providing security suggests that investments and external military interventions are complimentary. Foreign investors do follow the flag, as the literature suggests that a broad range of investment decisions are premised on the presence of particular interventions with the

presence of US troops serving as a catalyst for US FDI as it influences the destination and the volume of the investment (see Biglaiser and DeRouen 2007); US troops protecting against expropriation (see Jones and Kane 2005); and US troops attracting short term FDI, though long term US troop deployment signals unrest and discourages FDI (see Little and Leblang 2004). The stationing of US troops outside of combat also serves as a catalyst for US FDI as troop deployment for training signals greater military cooperation which could expand into better political and economic cooperation promoting greater US investors' interest (see Biglaiser and DeRouen 2007).

Additionally, the close cooperation between home country governments and foreign investors also serves as a 'follow the flag' factor, especially where national interests are at play. Governments often provide incentives and protection to its investors to commit to destinations of strategic importance or where they have national interests. For instance, the investment guarantee agency OPIC (Overseas Private Investment Corporation) serves to protect US FDI in places which carry considerable investment risks.[29] Therefore, US foreign investors are given inducements to invest in fragile states with the protection of the US government – therefore, the investment may not follow troop deployment but it follows US national interests which are protected by, if necessary troop deployment. If investors 'follow the flag' then this should suggest that foreign investors from the intervening country dominate the investment climate regardless of the sector or the threats facing the investors as the presence of the external military intervention mitigates the risks. However, 'following the flag' offers up another investment risks as MNCs following military interventions are often viewed as representing the interests of the intervening state, and if the intervention is unpopular

[29] These inducement include providing political risk insurance against host country contract renegotiation and expropriation and reducing the costs of financial capital. Because investment in developing countries carries risks especially if the country is affected by conflict, loans on such investments receive higher interest rates than investment carried out in stable countries. OPIC thus offers US MNCs guaranteed bank loans, bonds and other incentives that lower the risk premium on the interest rate (see OPIC, 2012).

and there is significant resistant against the intervention, then MNCs could be targeted as a method of forcing the external military to leave.

There are a number of ways in which foreign investors could follow external military interventions into conflict zones. Aside from the improvements in security and stability that a significant external military can bring, whereby the improved security could lead to a return of the investment friendly climate, foreign investors could accompany military interventions through the evolved role military interventions have in conflict zones. External military interventions are no longer about abating violence and ending conflict, but their role has evolved to include a wide set of additional functions such as restoring the rule of law, strengthening the democratic process and engaging with the private sector. The interventions engagement with the private sector is of particular importance because unlike its role in creating and strengthening legal institutions and promoting democracy which could take considerable time to develop, engaging with the private sector to create employment and other economic opportunities can often be done quite quickly and is seen an essential element of peace-building (see Gerson 2001 and Rettberg 2010).

It is increasingly common for military interventions to engage actively with the private sector by bringing private entities and private investment into the post-conflict recovery stage (see Kucik and Lo 2011), but this engagement also exists during armed conflict where military interventions engage in different operations which require the expertise of the private sector. For instance, external militaries engage with private security agencies in propping up location enforcement agencies by recruiting and training civilians to provide security. Additionally, to accelerate the process of ending conflicts, military interventions engage with private contractors in building local infrastructure and restoring key services such as water and sanitation which is paramount to stabilising

local societies and easing tension by those hostile to the intervention. Furthermore, the presence of an external military can also facilitate the role of development institutions such as the World Bank which bring additional investment as they seek to encourage foreign investment in public services and vital infrastructure such as telecommunications networks and the provisions of energy and clean water (see Schwartz et al. 2004). Providing such services can contribute towards developing local growth drivers which could ease poverty related causes of renewed conflict, whilst the recruitment of foreign investment in order to provide for local basic needs can lay the foundation for future post-conflict investment and development.

And finally as the role of military interventions have evolved so to have the structures and size of armies and peacekeeping units. External military interventions not just require military personnel, they also require logistical support services from preparing meals to cleaning as well as engineers to maintain and repair vehicles and aircraft including tanks and helicopters (see Pan 2004) which are often out-sourced to private civilian contractors. Therefore, the downsizing of armies to save costs has led to out-sourcing and the privatization of the military's logistical and support functions without which the intervention cannot take place.

2.14 Conclusion

The literature discussed above suggests that foreign investors are likely to be highly risk-adverse when faced with political instability and armed conflict, and are typically unwilling to accept the higher risk premiums associated with investments in conflict zones. This stems from the increase in the commercial and non-commercial risks of doing business in a politically unstable environment, causing prospective investors to avoid armed conflicts, whilst existing investors are likely to engage in capital flight and

portfolio substitution. The conventional wisdom therefore assumes that the armed conflict-FDI relationship is negative as political instability is bad for business. At the same time, however, the evidence suggests that the relationship between armed conflict and FDI is not as straightforward as the literature suggests. In order to address this research puzzle, this thesis focuses on explaining the paradoxical nature of the armed conflict-FDI relationship by exploring the following research question: *Why do countries involved in internal armed conflict continue to attract FDI?* In examining the armed conflict-FDI relationship in the chapters that follow, the thesis contributes to the existing debates on the complex economic effects of armed conflict, and especially within the context of the 'war renewal' school of thought.

CHAPTER 3 - METHODOLOGY

3.1 Introduction: Research puzzle and empirical investigation

This research project is conducted through a positivist perspective which uses a multi-method approach in answering the research question: *Why do countries involved in internal armed conflict continue to attract FDI (foreign direct investment)?* The conventional wisdom in much of the existing conflict literature suggests that civil war is 'bad for business', and will reduce rates of foreign investment as potential investors are unwilling to accept the higher risk premium associated with investing in conflict zones. This thesis explores the paradoxical nature of the armed conflict-FDI relationship, and suggests that although armed conflict is commonly assumed to deter new FDI, not all foreign investors follow the expected path of behaviour of avoiding armed conflicts. Based on this argument, the thesis examines the effect of external military intervention (EMI) as an independent variable on FDI, and suggests that foreign investments may be likely to occur during armed conflicts when independent states intervene with 'boots on the ground'.

3.1.1 Overview of the chapter

This chapter is divided in two parts. The first part begins by briefly discussing the main arguments from the literature on the relationship between armed conflict and FDI and then proceeds by explaining the two main investigations of the thesis. The first investigation is a time series cross-national analysis which uses descriptive statistics in determining correlation in aggregate FDI data of a large-*N* sample of armed conflicts. A time frame of 1996 to 2010 is chosen and the analysis is conducted through a series of hypothesis. The second investigation is a structured focused comparison on the case studies of Afghanistan (2003 to 2012) and Iraq (2003 to 2010), where the focus is on

disaggregating FDI and armed conflict data. Both investigations are structured to feed into the main research question: *Why do countries involved in internal armed conflict continue to attract FDI?* In addition to the two investigations, this thesis triangulates the data by presenting qualitative evidence on multinational corporations (MNCs) assessment of conflict affected risks and their reasons for investing in conflict zones. The second part of this chapter focuses on the methodological limitations of conducting a positivist empirical analysis. Here, the discussion focuses on the limitations of using FDI and conflict datasets, the use of aggregate data in determining correlation and the benefits of using a multi-method approach. The chapter then concludes with an overview of how the thesis is structured.

PART ONE:

3.2 The research puzzle

This PhD thesis challenges the conventional wisdom held in the current International Political Economy and Security Studies literature that the relationship between armed conflict and FDI is negative, as armed conflict deters new FDI while existing investors engage in capital flight (See Stewart and FitzGerald 2001, and Lindgren 2005). Although armed conflict increases the risk premium of doing business in conflict zones through exposing investments to asset destruction, asset theft, and market failure, a number of examples have emerged which illustrate that foreign investors are not uniformly risk-adverse. These include investments by Citibank ($24 million) and General Systems International LLC ($60 million) during the armed conflicts in Afghanistan and Iraq in 2004 and 2005, respectively. Therefore, these examples highlight the need to gain a better understanding of whether armed conflict is always

bad for business and to identify the reasons why foreign investors may decide to invest in countries affected by political instability.

This thesis explores the paradoxical nature of the armed conflict-FDI relationship through a multi-method approach, and suggests that although armed conflict is commonly assumed to deter new FDI, not all foreign investors follow the expected path of behaviour of avoiding armed conflicts. In doing so, this thesis examines the effect of external military intervention (EMI) as an independent variable of FDI, and suggests that foreign investment may be likely to occur during armed conflict when independent states intervene with 'boots on the ground'. This thesis also explores how the military intervention influences foreign investors by examining whether countries which intervene with 'boots on the ground' dominate the investment climate, and suggests that some evidence emerges which shows that foreign investors follow their countries' participation in an EMI into an armed conflict. Although the central argument fits around the independent variable of EMI, this thesis also explores whether the size of the investment and the sectors which appeal to foreign investors can explain FDI in armed conflicts.

3.3 Investigation 1 – Large-*N* quantitative analysis of FDI in armed conflicts

This thesis uses a multi-method approach in answering the research question: *Why do countries involved in internal armed conflict continue to attract FDI?* It begins with chapter 4 which uses a time series cross-national analysis to interpret aggregate FDI data in armed conflicts through four main lines of enquiry. The first line of enquiry is an analysis of FDI trends in a large-*N* sample of internal armed conflicts beginning from 1996 until 2010; second, it dichotomises the large-*N* sample and analyses FDI trends through conflict intensity; third, it applies the independent variable of external military

intervention and analyses whether FDI increases when independent troops intervene with 'boots on the ground'; and fourth, it examines whether FDI in armed conflict is a result of the EMI or because of reductions in conflict intensity.

The quantitative analysis is organised through the development of four hypotheses. These include:

H1: *Armed conflicts do not discourage all foreign investors, despite the increased commercial and non-commercial risks.*

This hypothesis argues that armed conflicts continue to attract FDI even though the key determinant of FDI – political stability – is absent from the investment climate. Finding support for this hypothesis could counter the theoretical arguments in the literature that armed conflict is bad for business.

H2: *High-intensity armed conflicts do not have a uniform negative effect on foreign investment.*

Conflict intensity is often argued in the literature as being a determinant of FDI providing that armed conflicts are fought with low levels of intensity. This is premised on the belief that low-intensity armed conflict presents fewer risks to the investment as: (i) it is fought with limited offensive capabilities and therefore armed violence can be confined to remote parts of the country and isolated away from commercial and investment intensive areas; and (ii) it only has short term effects where it dents investors' confidence without severely disrupting the investment climate – therefore armed conflicts which are fought with low-intensity are better able to attract FDI compared to high-intensity armed conflicts. High-intensity armed conflicts under this concept discourages FDI as it presents greater risks to the investment as: (a) spill-over of armed violence into commercial and investment intensive areas is more likely; and (b) it leads

to asset destruction and domestic demand shocks which not only impact on foreign investors but leaves a long term negative effect on the investment climate. These two contending views therefore necessitate this hypothesis to establish whether or not conflict intensity discourages FDI.

H3: *External military intervention (EMI) leads to increased FDI in high-intensity armed conflicts.*

If sufficient evidence can be found in support of hypothesis 2, then the next stage is to find a variable which could be used to explain this counter intuitive relationship. If foreign investors are able to tolerate the risks of low-intensity armed conflicts because of the fewer risks it carries, then what variable explains when and why foreign investors might tolerate the risks of high-intensity armed conflicts which can be expected to carry far greater risks to the investment? The third hypothesis introduces the independent variable of external military intervention (EMI) and argues that a military intervention can lead to increased FDI as it gives out 'positive signalling' which encourages foreign investment. The EMI implies that the investment climate will improve as the intervention serves to bring authority and stability to an incendiary economic and political environment. The introduction of this variable can offer, not only, an alternative explanation of FDI in armed conflicts alongside: (i) the heterogeneous behaviour of foreign investors; (ii) sector level perspectives; and (iii) conflict dynamics; but also expand on the literature on the role of an EMI in promoting FDI as currently this literature rests on its influence during peace time (see Lewis et al. 2010), in politically unstable but non-conflict countries (see Perez 2003 and DeRouen 2007) and in post-conflict reconstruction (see Pickering and Kisangani 2006, Ahern 2005, and Toal 2010).

H4: *External military intervention (EMI) increases FDI in high-intensity armed conflicts without reducing conflict intensity.*

The final hypothesis examines whether EMI increases FDI in high-intensity armed conflicts without reducing conflict intensity. The significance of this hypothesis emerges from the unpredictable relationship between EMI and conflict intensity and the resulting outcome on FDI. Although an EMI may be positively perceived by foreign investors as its presence could bring authority and stability to an armed conflict, the intervention could also have an adverse effect as it could lead to further deterioration of the political environment which could lead to several outcomes in FDI. For instance, foreign investors may follow an EMI into an armed conflict providing that the presence of foreign troops leads to a reduction in conflict intensity, which advertently reduces the level of risks of doing business in an armed conflict. Alternatively, foreign investors may follow an EMI into an armed conflict without any concerns that its presence may have little or no effect on conflict intensity, or that its presence may actually lead to an escalation in its intensity. Therefore, although, the previous hypothesis may be able to establish that EMI increases FDI, it may not take into account how the presence of foreign troops affects conflict intensity and whether increases in FDI is the result of the EMI or its impact on conflict intensity.[30]

3.3.1 Sample, datasets and additional variables

The sample for the quantitative analysis is designed through the use of conflict data taken from the Uppsala Conflict Data programme (UCDP) and Peace Research Institute Oslo (PRIO) Armed Conflict dataset (see Gleditsch 2002, and Themner and Wallensteen 2011), whilst FDI data is taken from the United National Conference on

[30] As political stability is a key determinant of FDI (see Woodward and Rolfe 1993, Schneider and Rey 1985 and Li 2006) and low-intensity armed conflict is theoretically more inclined to attract foreign investors based on the arguments provided by Berman (2000), 'improvements' in this hypothesis refers to a reduction in conflict intensity.

Trade and Development (UNCTAD) and the World Bank. The sample includes internal armed conflicts from 1996 until 2010 and this time frame is purposefully chosen as its offers a wide birth of armed conflicts for which data is available and reliable.

Internal armed conflicts have been chosen as the measure of armed conflict as after the end of the Second World War, they have emerged as the most dominant form of political violence (see Buhaug et al. 2007). Therefore, internal armed conflicts offer a far greater number of cases which can be analysed compared to international and interstate armed conflicts which have seen a reduction in their frequency. Additionally, internal armed conflicts are also seen as being more destructive to economic, political and social infrastructure which has far greater implications for foreign investors (see Li 2006) compared to other types of armed conflict. And as the nature of its armed conflict involves either the forceful change in government or the forceful seizure of territory, it is seen as a major deterrent to foreign investors which not only deters future FDI but also leads to disinvestment (see Collier 2004).

Although the core investigative focus of this thesis is on the independent variable of external military intervention (EMI), additional variables are included in order to consider possible alternative explanations. These variables are included in the discussion because of their potential influence over rates of FDI, as discussed in chapter 2. These variables include economic growth, geography (location), political system (democracy & government effectiveness), social factors (human development) and natural resources (resource endowments). Data for these variables are taken from the World Bank (economic growth, government effectiveness, and natural resources), the Polity IV project (democracy) and the UCDP/PRIO Armed Conflict dataset (location).

3.4 Investigation 2 – Structured focused comparison of Afghanistan and Iraq

Chapter 5 of this thesis is a structured focused comparison on armed conflicts in Afghanistan and Iraq which are analysed from 2003 to 2012 for Afghanistan, and 2003 to 2010 for Iraq. Chapter 5 takes the trends observed in the quantitative analysis and offers a narrow focused analysis of the armed conflict-FDI relationship by micro analysing the dynamics of armed conflict and disaggregating FDI. This is achieved through three lines of enquiry. First, it concentrates on the spatial dynamics of armed conflict; second, it focuses on the distribution of FDI through investment size and sector; and third, it examines whether the proportion of FDI can be tied back to either military contributions or to the geographic connection that exists between foreign investors and the investment destination.

The structured focused comparison is organised through the development of a series of questions for each line of enquiry. These include:

i. Spatial dynamics of armed conflict

1. What are the spatial dynamics of armed conflicts in Afghanistan and Iraq?
2. Are investments located in areas where armed violence is concentrated?

The spatial dynamics of armed conflict is a micro-focused analysis on how the spatial dynamics of armed conflict affects FDI. Although the quantitative investigation of this thesis dichotomises the large-*N* sample through conflict intensity, the observation only looks at armed conflict from a general point of view without taking into account its spatial dynamics. The above section briefly discussed how armed conflicts differ in their spatial dynamics as armed violence within an armed conflict could be isolated or widespread, and depending on its spatial patterns, foreign investors react accordingly. For instance, the conventional wisdom in the literature argues that foreign investors are

more likely to invest in armed conflicts providing that armed violence is isolated to remote parts of the country as the isolation of armed violence reduces the level of risk to the investment. Contrastingly, as widespread armed conflicts have a far greater geographic spread, the spill-over of armed violence into commercial and investment intensive areas often deters FDI as the lack of containment increases the commercial and non-commercial risks to the investment (see Berman 2000). Therefore, analysing the spatial dynamics of armed conflict and observing FDI during widespread armed conflict provides a narrow and informative understanding of the armed conflict-FDI relationship, as it takes the analysis away from the singular focus of the quantitative investigation.

ii. Distribution of FDI

3. Is the size of the investment a determinant of FDI in Afghanistan and Iraq?
4. Is the distribution of FDI sector specific in Afghanistan and Iraq?

The distribution of FDI during armed conflict is a large part of the armed conflict-FDI puzzle. Although the quantitative investigation of this thesis observes for FDI trends in armed conflicts, the analysis is based on aggregate FDI rather than sector specific FDI. This is based on the argument that FDI during armed conflict is dynamic and not static, as armed conflict generates market opportunities for adventurous investors in specific sectors. This argument stems from the theoretical discussions in the literature which suggests that during armed conflict, capital intense sectors often struggle to attract foreign investment as they require intense capital (financial, fixed assets and human) which increases their sensitivity to asset destruction and loss (including theft through expropriation), whilst potential losses through markets contraction or failure increases. Additionally, less capital intense sectors are often the most invested sectors during armed conflict as their fewer capital requirements reduces their potential losses in the

event the investment is destroyed, lost or fails (see Berman 2000). Therefore, concentrating on disaggregate FDI; in particular on the size of the investment and the sector which appeal to foreign investors can explain FDI in armed conflicts.

iii. 'Following the flag' or 'near home bias'

5. Do foreign investors 'follow the flag'?
6. Is the 'near home bias' influential in attracting FDI into Afghanistan and Iraq?

The final line of enquiry of the structured focused comparison revisits the role of an external military intervention (EMI) in increasing FDI, as it attempts to examine whether military contributions or the geographic connection between the investment and the investment destination can explain FDI in armed conflicts. The revisiting of this variable stems from the quantitative investigation which attempts to correlate increases in FDI to the presence of foreign troops, which if proven, requires an examination on whether FDI can be tied to military contributions through the 'following the flag' factor (see Biglaiser and Derouen 2007). Additionally, if FDI cannot be tied to military contributions, then it is possible that it could be tied to the geographic connection between the investor and the investment destination through the 'near home bias' factor (see Levis et al. 2010). In either event, correlating market opportunities which are generated by the EMI to either foreign investors 'following the flag' or foreign investors taking advantage of their 'near home bias' could further explain FDI in armed conflicts.

And finally, the thesis triangulates the use of the data in investigations 1 and 2 by presenting qualitative survey evidence on multinational corporations (MNCs) attitudes towards political risks. The survey provided by the World Bank offers nuanced arguments on how MNCs view the threats emanating from policy and security related risks and whether armed violence features highly in the decision making process of MNCs when selecting a location for their investments. The use of the survey is in

contrasts with the heavy reliance of hard data and therefore gives insights based on rational responses of MNCs operating in fragile and conflict affected countries.

3.4.1 Case studies – Afghanistan (2003 – 2012) & Iraq (2003 – 2010)

Afghanistan and Iraq have been chosen as the two most ideal case studies for a structured focused comparison as they both have a long history of political instability and armed conflict. Afghanistan has been involved in several continuous armed conflicts from the Soviet invasion of 1979 – 1989, the succeeding Afghan civil conflict of 1989 – 2001, and the subsequent internationalisation (intervention through an EMI) of its armed conflict when the US and ISAF/NATO (International Security Assistance Force, North Atlantic Treaty Organisation) forces intervened in 2001. Although the intervention was a response to the terrorist attracts of September 11, which led to the ousting of the Taliban from power, the international conflict quickly transformed into an internal armed conflict as the Taliban led an armed resistance against all occupying forces and the newly formed Islamic Afghan Republic.[31]

Iraq has similarly been involved in lengthy armed conflicts over the past 3 decades. This includes its interstate armed conflict with Iran in 1980 – 1988, the Gulf War of 1990 – 1991, its continuation in 2003 (second Gulf War) when the US and the 'Coalition of the Willing' (see Schifferes 2003) invaded, and the subsequent internal armed conflict which emerged soon after with the latter a consequence of the international conflict which led to the overthrow of Saddam Hussein's Ba'athist regime.[32] Although a new government was formed after the 'end of hostilities' were announced in May 2003, (see BBC news, May 2, 2003), an insurgency emerged which opposed all occupying forces and the newly formed government of Iraq. The situation further deteriorated when

[31] The official name given to the external military intervention in Afghanistan is Operation Enduring Freedom.
[32] The armed conflict in Iraq is also known as the War in Iraq, the Occupation of Iraq, the Second Gulf War (Gulf War II) and more officially Operation Iraqi Freedom.

intercommunal violence between the Sunni and Shi'a factions flared up in 2007 (see BBC news, February 2, 2007).

Although both countries have a long history of armed conflict, the structured focused comparison concentrates on the latter parts of their armed conflicts, which for Afghanistan concerns the internationalisation of its civil conflict from 2003 until 2012, and for Iraq concerns its internal armed conflict which began in 2003 and ended in 2010. The selection of Afghanistan and Iraq therefore provide this chapter with the two most appropriate case studies for a structured focused comparison as: (i) both armed conflicts run parallel with one another which allows for a thematic analysis, removes longitudinal changes and permits observations to be made over the same time period; (ii) both armed conflicts experienced an EMI which was on behalf of the non-state actor and against the government; (iii) their armed conflicts experienced an EMI which led to regime change; and (iv) their armed conflicts led to the emergence of an armed insurgency which attempted to overthrow the newly formed government.

3.4.2 Datasets

The data for the structured focused comparison are taken from two new datasets which are unique to the study of armed conflict and FDI. Armed conflict data is taken from the *Afghanistan/Iraq Coalition Casualty Count* (iCasualties) which records all incidents of armed violence against occupying forces and maps the geographic location where fatalities occurred.[33] As the investigation in the structured focus comparison concentrates on the spatial dynamics of armed conflict, it needs to establish whether Afghanistan and Iraq's armed conflicts were isolated or widespread. The use of coalition fatalities therefore allows chapter 5 to map the incidents of armed violence, as the iCasualties dataset provides accurate information on coalition fatalities and their location.

[33] iCasualties can be accessed at: http://icasualties.org/

Coalition fatalities are used over civilian fatalities because the data on coalition fatalities is available and reliable due to public disclosures of states involved in the EMI in Afghanistan and Iraq, and the reliability of their data. Although civilian fatalities represent the greatest proportion of all battle related deaths, the current accounting method is incomplete and unreliable which has necessitated the use of coalition fatalities.

Data on civilian deaths does exist through the *Iraq Body Count* and *Casualty Monitor* for Afghanistan, however, the completeness and reliability of fatality recording systems in both armed conflicts is widely questioned, whilst its limitations extends to its failure at not mapping where fatalities occur. Although some reputable data is available on civilian deaths through authoritative datasets which includes the Correlates of War project (COW) (see Doyle and Sambanis 2000, and Fearon and Laitin 2003), the data is in an aggregate form, whilst UCDP/PRIO Armed Conflict datasets does provide disaggregate data through its ACCLED dataset (The Armed Conflict Location and Event dataset), however, its dataset is specific to the African region with no data on Iraq currently available (as of 2nd October, 2013).

FDI data is taken from FDI Markets which tracks all Greenfield foreign investments. Chapter 4 uses FDI data which is taken from the United Nations Conference on Trade and Development (UNCTAD) and the World Bank, however, as chapter 5 disaggregates FDI; data from FDI Markets is the most appropriate.[34] This dataset offers information relating to the location of the investment which includes the destination of investors operations, the size in US dollars and the market sector where the investment is located. This dataset also provides useful information on the investor, including their geographic identity and market value of the investment.

[34] FDI Markets is part of the *Financial Times* and can be accessed at: http://www.fdimarkets.com/

PART TWO:

3.5 Data concerns and a reflection on the methodology

This thesis uses 6 different datasets, so the first challenge it must address is the availability and reliability of data – which is a common challenge in empirical investigations which look at the economic effects of armed conflict. The first challenge of this thesis is to design a sample using a time frame which offers a wide birth of cases for which data is available and reliable. This thesis has selected 1996 to 2010 as the time frame for the time series cross-national analysis and 2003 until 2012 for the structured focused comparison. For the time series cross-national analysis, armed conflict and EMI data is taken from the Uppsala Conflict Data Programme and the Peace Research Institution Oslo (UCDP/PRIO) Armed Conflict dataset (see Gleditsch 2002, and Themner and Wallensteen 2011), whilst economic data is taken from the United Nations Conference on Trade and Development (UNCTAD) and the World Bank. Data for additional variables is taken from the World Bank (economic growth, government effectiveness, and natural resources), the Polity IV project (political) and the UCDP/PRIO Armed Conflict dataset (location). The data for the structured focused comparison is taken from iCasualties and FDI Markets, and as the datasets are provided by reputable and authoritative sources, very little concerns exist with the reliability of the data.

During peacetime, the accuracy of data tends to be less controversial than during armed conflict when data accuracy and reliability is more frequently challenged. This stems from the failure of governmental institutions in keeping accurate records whilst International Organisations often find it difficult to verify data which is released by governments. In particular, data which is released by governments during armed

conflict is viewed with scepticism as governments often aim to distort the true reality on the ground. This includes the role of data in propaganda wars between different groups of antagonists in armed conflicts. For instance, in the context of attracting FDI, governments could distort the reality on the ground by releasing misleading data to show that economic opportunities still exist despite the lack of political stability. In addition, non-state actors also release misleading data to show that their war aims have been achieved. Therefore, until this data is verified by reputable organisations such as the United Nations or the World Bank, it must be taken with caution.

If governments do release data, then often it is missing due to the failure of governmental institutions in keeping complete records. This often happens when armed conflicts escalate to the point where governments prioritise security institutions over economic and social institutions, and reallocate funds into the war effort. This leads to the weakening of non-military institutions which no longer function effectively and leads to the emergence of informal economies. If governments are still able to record some data, then often this data is partial as it is does not include informal economies. Additionally, if government territory is lost during armed conflict, then any economic activity which falls in this territory is not accounted for in government records.

3.5.1 Internal armed conflict and the agreed upon principles

The large-*N* sample is made up of internal armed conflicts, and although it seems that internal armed conflicts are easy to define, there is no real common definition within the discipline. Although differences exist, the discipline is united in accepting that there are agreed principles which define an internal armed conflict. This includes: (i) the principle that armed violence must be contested between a conventional government and a non-state actor where the antagonists are inhabitants of the state or of its territory;

(ii) the principle that armed force is used which leads to fatalities exceeding the minimum threshold set to define it as an armed conflict; and (iii) the principle that the incompatibility must include the forceful change in government and/or the forceful acquisition of territory for self-determination or autonomy.

Although these three principles help separate internal armed conflicts from other forms of political instability, the definition is still clouded in ambiguity. For instance, the first principle insists that internal armed conflict must be strictly between the state and a non-state actor where armed conflict is contested within the borders of that state. Although this principle guarantees that armed conflict is 'internal', in most internal armed conflicts, external interference are widely reported, either through the participation of independent states or the participation of non-state actors from third-party states. For example, the armed conflict in Syria is classified as an internal armed conflict as it is contested between the government and a non-state actor of the state, however, it is widely understood that there is significant third-party interference from either independent states or non-state actors from third-party states. This interference has internationalised an internal armed conflict which is very common in these types of conflicts. Therefore, any external interference has to be accounted for as it has the capacity to alter the dynamics of an internal armed conflict, as some scholars such as Singer and Small (1982) argue that any external interference in an internal armed conflict should re-define the conflict as either an interstate or an internationalised armed conflict.

The second principle insists on the use of armed force which also presents certain challenges. This principle insists that armed force is a necessary condition of armed conflict, and its use must lead to fatalities which can distinguish armed conflict from other forms of armed violence. In most conflict datasets, battle related deaths are used

as a measure to distinguish between legitimate armed conflicts and acts of violence which stem from criminal behaviour. A minimum threshold is set which must be met in order for an act of violence to be coded as an armed conflict. As there is no common definition of an internal armed conflict, there is no universal threshold that can be applied to armed conflicts as each dataset has its own minimum threshold.

Some datasets which include the UCDP/PRIO Armed Conflict dataset suggest that the minimum threshold should be 25 battle related deaths, whilst some datasets including the COW project set their minimum threshold at 1,000 battle related deaths. The difference in the minimum threshold leads to two main problems: The first problem stems from low thresholds which lead to small or minor acts of violence being considered as armed conflict, whilst the second problem stems from the higher minimum thresholds which often excludes legitimate armed conflicts. For instance, the armed conflict in Northern Ireland is excluded from the COW project but included in the UCDP/PRIO Armed Conflict dataset.

Additionally, conflict datasets also set different thresholds to measure conflict intensity. The UCDP/PRIO Armed Conflict dataset stresses that armed violence must meet the minimum 25 battle related deaths before it can be considered as an armed conflict with less-intensity (minor), whilst exceeding over 1,000 battle related deaths transforms a minor armed conflict into a high-intensity armed conflict (War). Although these categories are helpful in distinguishing between less and high-intensity armed conflicts, the lack of universal coding amongst the datasets often leads to one dataset coding an armed conflict as being of high-intensity, whilst other datasets code the same armed conflict as being of less-intensity.

And the final principle of incompatibility which insists that all internal armed conflicts must include the forceful change of government and/or the forceful acquisition of territory for self-determination also presents some challenges, as numerous examples show that criminal groups also vie for control of territory. Under this principle, criminal groups such as the drug cartels in Mexico could also be considered as actors to an internal armed conflict as the Mexican drug wars has led to large government territory falling under the control of drug cartels.[35] Although the control of government territory does not include self-determination or autonomy, the drug cartels have administered their own self-rule and governance away from government control which does qualify it under the principle of autonomy.

The lack of clarity in the definition of an internal armed conflict within the datasets does cause problems when attempting to code armed conflict as too often acts of violence from criminal groups could easily meet the principles for coding an armed conflict. Taking the Mexican drug wars as a prime example, all four principles are achieved even though armed conflict datasets exclude it from their records as they class it as violence perpetrated by criminal groups. However, under their coding system, the Mexican drug wars fit the description of an internal armed conflict as it (i) meets the principles of contestation as it is a non-state actor fighting against the state and using armed violence; (ii) the violence has led to over 30,000 deaths therefore classifying it as a high-intensity armed conflict especially within the COW and UCDP/PRIO Armed Conflict dataset and; (iii) incompatibility of the conflict is to contest the government for its territory which it has achieved as it controls significant swaths of land especially on the US-Mexico border.

[35] The Mexican Drug war is an on-going armed conflict taking place between rival drug gangs for regional control of the lucrative drugs market in the US, and the Mexican forces who seek to combat drug trafficking. The level of violence has exceeded the minimum thresholds for internal armed conflict and war – however as the drug war prerogative is not to change government or appropriate territory and the operations of the drug gangs is criminality, it is classified as being internal armed violence rather than internal armed conflict.

3.5.2 Definition of internal armed conflict

Although there is ambiguity in the definition of internal armed conflict, this thesis has selected Gleditsch et al. (2002) definition of internal armed conflict, and the corresponding data from his dataset – the UCDP/PRIO Armed Conflict dataset. Although Gleditsch's definition includes the same principles discussed above, his definition has been chosen as it has a separate coding for internal armed conflicts which receive third-party interference. Therefore, internal armed conflict is defined as *"an armed conflict which occurs between the government of a state and one or more internal opposition group(s) without intervention from other states"* (p.7). All internal armed conflicts which receive third-party interference are coded as internationalized internal armed conflicts; however, Gleditsch defines third-party interference as the intervention of independent states with 'boots on the ground' (EMI) and therefore excludes the participation of non-state actors in internationalized internal armed conflicts. Therefore, internal armed conflicts which receive an external military intervention (EMI) are defined as: *"an armed conflict occurring between the government of a state and one or more internal opposition group(s) with intervention from other states (secondary parties) on one side or both"* (p.7).

3.5.3 Conflict datasets and the use of battle related deaths

This thesis uses the UCDP/PRIO Armed Conflict dataset, and an important element of all conflict datasets is the use of battle related deaths in coding armed conflict. All authoritative datasets including the Correlates of War project (COW) and the UCDP/PRIO Armed Conflict dataset use battle related deaths in determining data on armed conflict. This includes coding its onset, duration and intensity through the use of battle related deaths, and although the use of battle related deaths is the most dominant

form of deriving information on armed conflict, certain analytical limitations exist which require some clarification.

3.5.3.1 Battle related death thresholds

The first limitation (as discussed briefly in section 3.5.1) emerges from different thresholds which are used to identify the start and end of an armed conflict as well its level of intensity. Different datasets have different interpretation on battle related thresholds which often lead to inconsistent data when using multiple datasets or when using different datasets to confirm conflict data.[36] The inconsistency begins when datasets set threshold to code armed conflict or to determine the point when acts of armed violence transform into a defined armed conflict. The UCDP/PRIO Armed Conflict dataset insists on a minimum threshold of 25 battle related deaths before armed violence can be coded as an armed conflict, with 1,000 battle related deaths a minimum requirement for armed conflict to be classified as a high-intensity armed conflict (war). Other datasets which include the COW project have their own unique thresholds which differ depending on how they define armed conflict, and as no scientific evidence exist to justify what the threshold should be; a degree of variance exists across all the different conflict datasets.[37]

Additional to the lack of consistency in battle related death thresholds, the exclusion of legitimate armed conflicts is also a problem that conflict datasets have yet to solve. The

[36] In the large cross-country datasets which provide time series analysis, the different coding rules governing conflict related deaths have led to wide variations in the data which yield unexpected and inconsistent data when referenced with other datasets. If data from each dataset is merged, the wide variations prohibit clear comparisons from emerging whilst also confusing the explanation on the dynamics of conflict. This can be best illustrated by using a study pioneered by Restrepo, Spagat and Vargas (2004) who highlight the limitations and wide variations in the data of large cross-country datasets and advocate for more in-depth micro analysis of each conflict. In a study comparing their micro data on Colombia's internal armed conflict against 13 large cross-country datasets, the authors found wide variations in all of the data due to different coding rules which were based on battle related deaths. For instance, all 13 datasets gave a different start date for the Colombian conflict with a start date variation of 23 years (Fearon and Laitin (2002) gave the Colombian Conflict a start date of 1963, while the World Military and Social Expenditures (WMSE) (Sivard, 1991) gave an alternative start date of 1986) whilst differences also ranged to the number of participants and key actors to the conflict. Of most concern were the wide variations in conflict intensity within the datasets the conflict. The authors found that the datasets were severely underestimating the intensity of the conflict. The significance of underestimating conflict intensity is important to this thesis as it is integral to investigating the impact of conflict on FDI.

[37] For a brief discussion on using battle death thresholds in coding internal armed conflict see Sambanis (2001) and for a discussion on different thresholds amongst the various conflict datasets see Restrepo, Spagat and Vargas (2004).

UCDP/PRIO Armed Conflict dataset has a lower level minimum threshold of 25 battle related deaths; however, other datasets including the COW project have a far higher minimum threshold of 1,000 battle related deaths which leads to the exclusion of legitimate armed conflicts which register fewer battle related deaths. For instance, comparing the inclusion of armed conflict from the COW project against the UCDP/PRIO Armed Conflict dataset, the COW project excludes armed conflicts which registered fewer than their required 1,000 battle related deaths. This includes the Northern Ireland armed conflict which registered less than its minimum threshold, and although it did not meet the requirement of the COW project, it was included in the UCDP/PRIO Armed Conflict dataset.

Additional to the limitations discussed above, problems with identifying the start dates and duration of armed conflict is also another challenge which emerges from the use of battle related deaths. The start date of an armed conflict is often recorded from the moment the first fatality is identified; however, if the minimum threshold is not met within 12 months of the first fatality, no official start date is given to the armed conflict. Although the minimum threshold may be met over a longer period of time, conflict datasets insist on all thresholds being met within 12 months of the first fatality in order for them to consider armed violence as an armed conflict. This leads to the exclusion of legitimate armed conflicts which may not accumulate sufficient battle related deaths in the given time frame, even though they might accumulate a greater number of battle related deaths over a longer period of time.[38]

Once an armed conflict has begun, datasets insist that the duration of an armed conflict is dependent on sustained violence for each of its year of armed conflict, which can only be achieved through meeting the minimum threshold for battle related deaths. If an

[38] For instance the Northern Ireland conflict accumulated over 3,000 battle related deaths during its armed conflict, yet it is excluded from the higher threshold conflict datasets as it did not accumulate 1,000 battle related deaths in a given year.

armed conflict continues to record battle related deaths but does not meet the minimum threshold, then that year of armed conflict is coded as inactive, until the minimum threshold is met. The use of battle related deaths to code an on-going armed conflict fails to take into account fluctuations in conflict intensity which is measured through using battle related deaths. As armed conflicts are fought with different degrees of conflict intensity, any reductions in its intensity are not accommodated for in the datasets, as most datasets do not offer different thresholds to measure conflict intensity. The UCDP/PRIO Armed Conflict dataset is able to factor in changes in conflict intensity as it assigns a minimum (minor) threshold for the inclusion of armed conflict and a higher threshold for the inclusion of high-intensity (war) armed conflict.[39]

3.5.3.2 Battle deaths vs. total deaths

The next limitation coming from the use of battle related deaths is whether conflict datasets should use total deaths which include civilian fatalities or limit it to just battle related deaths which only include combatants. Presently, conflict datasets only use battle related deaths which include only combatants and exclude all civilian deaths, even though civilian deaths represent the larger proportion of all battle related deaths (see Sivard, 1996; Chesterman, 2001 and Clodfelter, 2002). One of the reasons why conflict datasets limit themselves to combatants is because of the poor recording systems in place for recording civilian deaths. Often, governments involved in internal armed conflicts fail to record civilian deaths, whilst international organisation cannot verify any data that governments release.

[39] These datasets are only a few amongst many others. Restrepo, Spagat and Vargas (2004) have listed 13 major conflict datasets in their study on the Colombian civil war which all offer different battle related thresholds. These include: civil war termination (see Licklider, 1995); Correlates of War (COW) – civil war (see Sarkees, 2000); Doyle and Sambanis civil war (2000); Fearon and Laitin – civil war (2002); International Institute for Strategic Studies (2004); Interdisciplinary Research Programme on Causes of Human Rights Violation - PIOOM, (see Jongman, 2002); Project Ploughshares (2004); Stockholm International Peace Research Institute – SIPRI (2004); State Failure Task Force – SFTF (see Marshall et al, 2002); Third party Intervention (see Regan, 2002); Uppsala Conflict Data Project (UCDP), Uppsala University and International Peace Research Institute, Oslo (PRIO); Uppsala/PRIO (see Erikson, 2004); Uppsala Conflict Data Programme – UCDP (2004); and World Military and Social Expenditures – WMSE (see Sivard, 1991).

The use of only combatant deaths in conflict datasets does not give an accurate reflection on the true extent of human suffering or the ferocity of an armed conflict. Scholars, including Sarkees and Singer (2001) and Doyle and Sambanis (2000) suggest that greater focus must be placed on the inclusion of civilian deaths in datasets rather than simply relying on the death of combatants, as civilians are often targeted in armed conflicts. This coincides with Newman (2009) who argues that civilian casualties and forced human displacement are dramatically increasing as a proportion of all casualties in conflict and civilians are increasingly deliberately targeted as an object of new wars. Therefore the inclusion of civilian deaths alongside battle related deaths reveals the true extent of an armed conflict.

3.5.3.3 Absolute figures vs. capita figures

The final limitation stemming from conflict datasets and the use of battle related deaths is whether fatalities should be premised on absolute figures or in relative terms (i.e. in capita), especially if the data is used for cross-country comparisons. Currently, conflict datasets use battle related deaths in absolute terms which is more appealing and practical as it refers to the physical destruction of a certain magnitude. Although absolute figures dominate conflict datasets, its accuracy is questioned when making cross-country comparisons as it does not take into account population size when illustrating the scale of armed violence. For instance, conflict datasets will show that high-intensity armed conflicts where 1,000 battle related deaths have been accumulated experienced similar levels of armed violence; however, this indication is misleading as population size amongst the sample may vary widely. If population size is considered, the data could reveal that one country in the sample has a population twice the size of another, which indicates that the level of destruction it faces is less compared to the country which has the smaller population. Therefore, until population size is factored in,

absolute figures will not be able to provide an accurate assessment of the destruction caused by armed conflict, as well as making it difficult to make cross-country comparisons.

Additionally, the use of absolute figures also leads to the exclusion of legitimate armed conflicts which are excluded from conflict datasets because they record fewer battle related deaths than the minimum threshold. If battle related deaths per capita is used, then conflict datasets may be more inclusive as armed conflict which miss out in absolute terms may be included in relative terms. Although relative terms seems like a more fairer reflection of armed conflict, it too has its own limitation as it could exclude armed conflicts which accumulate a high number of battle related deaths which are rendered insignificant due to its large population size.[40]

3.5.4 Use of aggregate data and methodological debate

The research described in this thesis interprets data at a national level and attempts to identify and explain cross-national patterns of FDI in situations of armed conflicts. It also aggregates data for all the independent variables including external military intervention as well as a broad range of economic, political and social variables. The value of using aggregated data enables this thesis to draw upon a highly developed range of datasets where cross-national comparisons in FDI can be made in order to help us understand how foreign investment reacts to the start of an armed conflict, or indeed why foreign investment is likely to occur or even increase during an armed conflict in certain circumstances (for example, if foreign states intervene with military troops).

When looking into the FDI-armed conflict relationship it is generally necessary to use aggregate data for FDI as the World Bank and the United Nations Conference on Trade

[40] Sambanis (2001) suggest that a solution to the limitations of using absolute figures is to use a typology of absolute and per capita figures by generating a per-capita death measure which could be used in conjunction with conflict thresholds. However, he does concede that creating a per capita measure of battle related deaths is difficult and labour-intensive.

and Development monitor at the national level. There is a move in conflict research towards the use of disaggregated data where it is available, and clearly this contributes much to our understanding of conflict, in particular micro-dynamics. However, national level data does enable this thesis to seek an understanding of the FDI-armed conflict relationship through cross-national comparisons, with hypothesised patterns selected for further quantitative assessment. The value of this thus allows this thesis to interpret and identify the relationship status of the variables before moving to a more rigorous micro-focused analysis.

Looking at the rate of FDI by countries is a 'natural' sample fit as data is more readily available at this level compared to sub-national levels. However, when it comes to armed conflict, the state as a unit of analysis is problematic because local level drivers often define the true nature of armed conflicts. Armed conflicts are defined by their unique characteristics whether this stems from the antagonists, to conflict onset and dynamics (intensity, severity and spatial patterns) or to their historical legacies. As these variables help to explain the nature of armed conflict, it is important that these variables are analysed independently as aggregating them tends to simplify their importance and obscures critically important local patterns. This then leads to assumptions that the state is the arena of contestation when in reality the defining features of an armed conflict lay at the local level (see Newman 2014).

Although this thesis uses a positivist multi-method approach where aggregate data is used for FDI and armed conflict, it does, where possible, address the limitations of this technique by using micro-focused data of FDI and armed conflict in order to explore in finer detail the patterns identified at the national level. This is achieved by looking at variables which identify the unique characteristics of each armed conflict and variables which can disaggregate national level FDI data.

Investigation 1 begins by analysing national level FDI data of a large *N*-sample of internal armed conflicts with the sole purpose of identifying the relationship between FDI and armed conflict. As all armed conflicts have unique characteristics, this investigation then separates the sample through conflict intensity, and although the analysis remains at the national level, the patterns identified here allow the investigation to move towards a narrower and micro-focused analysis. The method adopted here is to use descriptive statistics to determine correlation[41] by representing the data in a meaningful way so that patterns can be identified between the variables. In this investigation, the data is simply interpreted without drawing firm conclusion that the relationship between the variables represents causation.[42]

Investigation 2 is where the limitations of using aggregate data are addressed. In this investigation two cases are selected where local level dynamics are analysed against FDI flows, with FDI data further disaggregated in order to understand whether particular investment variables affect investment decisions. The variables used for disaggregating armed conflict include the location of armed violence, and with respect to FDI the analysis includes the source of the investment, its location, size and industrial sector. In addition, the independent variable of external military intervention is also disaggregated in order to analyse whether a relationship exists between the composition of the EMI and the source of the investment. By disaggregating these variables, investigation 2 is able to generate more detail knowledge about FDI flows in armed conflicts, and presents interesting findings which may have been overlooked by national level analysis.

[41] Although in positivist empirical studies correlation between a dependent and independent variable can be achieved - which can be tested through various datasets that have been developed – a positivist approach often struggles to explain causal mechanisms. The assumption of a linear relationship between variables does not address the possibility of reverse causation and therefore it is not always clear which direction the causal process is working (see Newman 2014).

[42] However, illustrating a relationship between the variables can give an indication of a causal relationship where an independent variable produces a change in the dependent variable. Although this shows that a relationship exists, this form of analysis cannot conclusively demonstrate a causal process (see Clayton, 2014).

The philosophical position taken by this thesis rests within a positivist paradigm as empirical data is emphasised in the investigations. Although a positivist empirical methodology is appropriate in tackling the research question, within the social sciences, and in particular in the study of civil war, questions are raised on the methodology, ontology and epistemology of the field. This reflects a broader debate in the social sciences between positivists' scholars who claim that there is value-free 'truth' and that knowledge can be created through impartial analysis which is free from research bias, and critical scholars who are sceptical of this research for 'scientific' objectivity.

According to the positivist worldview, it is possible to generate rigorous explanatory theory, through observation and testing, on a range of empirical questions related to the causes and nature of civil war, and in relation to this thesis, on the impact of civil war on foreign direct investment. This approach is seen in both single-case analysis and in cross-country studies that seek to generate conclusions that have explanatory relevance in different contexts. These empirical approaches generally place an emphasis upon theoretical parsimony and coherence by identifying the significance of a single variable in explaining a research problem, which in the context of this thesis rest with external military intervention. In addition, positivists also apply a rationalist worldview on the part of actors involved in civil war where the implication rests on the universal foundation to knowledge, whilst also assuming that the variables relevant to the study of civil war can be compared irrespective of regional or temporal context (see Newman 2014).

Within the empirical approach to the study of civil war there are further differences in methodology. Quantitative empirical approaches codify and measure social phenomena in order to perform cross-country analyses. They favour a materialist approach to analysis and they consider the significance of different measureable variables for

processes and events related to civil war. Econometric approaches codify large amounts of data from several datasets and seek to identify meaningful relationships between variables. This approach can lead to probabilistic and testable conclusions on the likelihood of particular outcomes in armed conflict. These empirical approaches reflect the belief that 'scientific' approaches are possible and that reliable knowledge can be generated about civil war which is not only specific to particular cases but can also be extrapolated as a general phenomenon.

Moving away from the positivist 'scientific' methodology to the study of civil war, critical and post-positivist scholars reject the idea of objective and value-free scholarship and reject the assumptions of rationalist, material models, whilst challenging the positivist preference for parsimony and universalist explanations for armed conflict (see Moore 2010). The critical approach argues that understandings of armed conflict must be based at the local level rather than the national, with emphasis given to local dynamics. In addition, critical theorists reject the positivist assumptions of rationality on part of the actors or those involved in armed conflict, and reject the idea that armed conflict can be simplified into observable variables, but instead argue that armed conflict could be understood in the context of local meanings and institutions, including the experience of ordinary people.

Although positivist and post-positivist/critical theorist are two contending approaches and can lead to contradictory findings, this does not imply that either approach to the study of civil war or to the development of knowledge is wrong. Instead, these approaches reflect the diversity in social science research and within the parameters of their methodologies; their conclusions should be seen as contributing to the study of civil war.

3.6 Integrating quantitative and qualitative research –'logic of triangulation'

The use of a multi-method approach has been designed to give this thesis a broader base from which to answer the research question: *Why do countries involved in internal armed conflict continue to attract FDI?* By using a multi-method approach – which consists of a quantitative analysis through the use of descriptive statistics, a structured focused comparison and surveys of multinational corporations (MNCs) attitudes towards armed conflict – this thesis takes advantage of the potential to use one method to reinforce the findings of the other, to use the strengths of one method in overcoming the limitations of the other, and to further the development of knowledge.

Quantitative and qualitative approaches are primarily concerned with the collection of data appropriate for the theoretical and empirical design of the research project. This PhD thesis has designed an empirical research project consisting of a series of hypothesis for the quantitative analysis and a series of questions for the structured focused comparison alongside an attitude survey of MNCs. These hypothesis and questions feed into the main research question: *Why do countries involved in internal armed conflict continue to attract FDI?* In order to do so, this PhD thesis has identified that the combination of both quantitative and qualitative approaches are needed, as both methods are relevant at different stages in the research process.

The research project in this thesis begins by using a quantitative approach in examining the armed conflict-FDI relationship, by firstly clarifying whether armed conflict is always bad for business; secondly, identifying the reasons why foreign investors may decide to invest in countries despite the instability associated with continuing armed conflict; and thirdly, understanding whether FDI increases because of the external military intervention (EMI) or because of reductions in conflict intensity. As a large-*N*

sample is employed, the objective of the quantitative investigation is to build a general understanding of the armed conflict-FDI relationship by identifying trends in FDI in a wide sample of armed conflicts. This large sampling of cases, therefore allows the thesis to observe for insights which could be further examined through a more narrow research approach.

The second approach is a narrow focused investigation which uses a structured focused comparison of furthering the knowledge developed in the quantitative investigation. This approach confines the analysis to two particular case studies which have an element of similarity but also a degree of variance. This is to ensure that the generalisation drawn from the quantitative investigation can be observed in a more tightly controlled environment where both case studies share similar variables which could be influential in attracting FDI, as well as ensuring that any new knowledge created through the structured focused comparison is consistent between the two case studies.

The structured focused comparison is an examination of Afghanistan and Iraq's armed conflict, which uses a series of questions in answering whether the spatial dynamics of armed conflict affect FDI; whether the size and sector can explain the distribution of FDI; and whether FDI can be tied back to military contributions through the 'following the flag' factor or connected to the geographic proximity between the investor and the investment destination through the 'near home bias' factor. Each area is directly linked to the main research question: *Why do countries involved in internal armed conflict continue to attract FDI?* The spatial dynamics of armed conflict offers an explanation premised on conflict dynamics as it suggests that FDI could be dependent on armed conflict being isolated, therefore ensuring that conflict affected risks are at a minimum; the size and sector of FDI offers an explanation premised on foreign investors

minimising their losses by making smaller investments which require less capital; and the 'following the flag' and 'near home bias' offers an explanation that foreign investors follow their countries military contribution or take advantage of their geographic connection with the investment destination in making investments in armed conflicts.

Tied in with these approaches, qualitative survey evidence is also presented which enables this thesis to triangulate the data. The survey offers responses of multinational corporations (MNCs) towards armed conflict acts to validate the conclusions drawn from the use of hard data, but also offers further insights on whether armed conflict has the expected impact on foreign investment as the theoretical literature argues.

By integrating two methodological approaches, this thesis encounters a challenge which traditionally draws on the debate within the social sciences as to whether two contending approaches can be combined in a single research project. Scholars such as Webb et al. (1966) argue that social scientist can exhibit greater confidence in their findings if more than one research method is applied to a research problem. This method, called the 'logic of triangulation' enables researchers to use a range of different techniques in the measurement of the main variables – thus permitting researchers to conduct research in which multiple observations, theoretical perspectives, sources of data and methodologies are combined (see Denzin, 1970). Within this context, the 'logic of triangulation' or multi-method approach allows researchers to examine the same research problem through different research method[s] thus enhancing the validity of the researchers claims, especially if the different methods of investigation provide mutual confirmation of their findings.

An additional benefit to this multi-method approach is that it does not confine itself to just enhancing the validity of results as mentioned above, but also lends itself to

providing a platform from which researcher could use the results of one research method as a precursor to the formulations of problems and hypothesis to be tested by the other research method. For instance, Brymen acknowledges that 'qualitative research may act as a source of hunches or hypotheses to be tested by quantitative research' (1988. P. 134) – therefore, the presence of the qualitative investigation can greatly assist the development and analysis of the quantitative investigation and vice versa. As part of developing new hypothesis, the multi-method approach can also be seen as a process in which researchers can use multiple research methods consecutively in a typology of sub investigations which are eventually combined to provide a general picture of the research problem. As quantitative and qualitative methods may be relevant at different stages of the research process, researchers can design research projects where different research methods are employed to tackle different aspects of the research problem, which combined contributes to the overall aims of the researcher.

3.7 Conclusion

This chapter has explained the research puzzle and set forth the logical sequence of how the thesis will answer the research question: *Why do countries involved in internal armed conflict continue to attract FDI?* In doing so, this chapter explained the multi-method approach of this thesis which includes a quantitative analysis in chapter 4 and a structured focused comparison in chapter 5 with qualitative survey evidence of MNCs attitudes towards conflict affected risks. This chapter also explained the methodological challenges that this thesis could encounter and the benefits of using a multi-method approach in an empirical research project.

The next chapter begins the empirical investigation with an examination of the armed conflict-FDI relationship. This is conducted through an analysis of FDI trends in a

large-*N* sample of internal armed conflicts beginning from 1996 to 2010. Through the use of descriptive statistic, chapter 4 establishes whether armed conflict deters new FDI and identifies the reasons why foreign investors may decide to invest in countries despite the instability associated with armed conflict.

CHAPTER 4: THE PARADOXICAL NATURE OF ARMED CONFLICT AND FDI

4.1 Introduction: What explains FDI in armed conflicts?

Can international business and internal armed conflict co-exist? Can countries involved in armed conflict attract foreign investors? Do foreign investors still invest in conflict zones despite the risks? These are common questions in the literature on the relationship between armed conflict and FDI. In broad terms, existing works suggest that foreign investors do not like political instability (see Woodward and Rolfe 1993, Schneider and Rey 1985 and Li 2006); that the onset of armed conflict leads to disinvestment[43] and portfolio substitution (see Collier 1999, Imai and Weinstein 2000 and Collier et al. 2004) and that durational and widespread armed conflict leads to the loss of potential international capital as foreign investors are unwilling to accept the higher risk premium associated with investments in conflict zones (see Asiedu 2002 and Pierpont and Krueger 2005). These theoretical arguments indicate that armed conflict discourages FDI as political instability is bad for business; however, there is sufficient evidence to show that the relationship between armed conflict and FDI is not as simple as the literature suggests.

A recent example from Iraq helps to illustrate that foreign investors are not uniformly risk-adverse with respect to investment in conflict zones. On July 15 2011, two car bombs exploded in the city of Kerbala in Iraq killing a total of seven people and wounding 19.[44] On the same day, American soldiers and Iraqi policemen were killed by a sticky bomb in Baghdad, while more bombs wounded soldiers in Samarra and Mosul. These violent incidents were part of a larger internal armed conflict which had begun

[43] Disinvestment is also referred as reverse investment or capital flight.
[44] According to the UCDP/PRIO Armed Conflict Dataset (see Themnér and Wallensteen (2011), Iraq had been involved in an high-intensity internal armed conflict from 2004 onwards. Although the latest version of the dataset only extends to 2010, the level of deaths registered post 2010 indicates that its internal armed conflict is still active.

soon after the US invasion of Iraq in 2003, which proceeded to not only continue the deterioration of the country's economic and political stability but also to continue the worsening of its investment climate. On the very same day when US soldiers were attacked and minutes away from the sticky bomb incident, Baghdad's renowned Al-Rasheed hotel was ceremoniously re-opening after undergoing a $65 million investment following damage sustained during the conflict years. What was striking about this was – not only that the re-opening was taking place at a time when Iraq was embroiled in an high-intensity and active armed conflict – but at the heart of the investment were two international companies which included the British construction company Harlow International and Holland's Kempinski hotel group.[45] The investment of these companies in a country which at the time was involved in a high-intensity armed conflict implied that not all foreign investors were discouraged by armed conflict, despite the increased level of commercial and non-commercial risks.

Although the investment of Harlow International and Kempinski hotel group is only one example of international investments in armed conflicts, it is now part of a larger collection of international investments in conflict zones which has created a research puzzle for understanding armed conflict-FDI dynamics. This research puzzle which stems from the limitations in the current literature asks a key question: *Why do countries involved in internal armed conflict continue to attract FDI?* This suggests the need to clarify whether armed conflict is always bad for business, and to identify the reasons why foreign investors may decide to invest in countries despite the instability associated with continuing armed conflict.

This chapter explores the paradoxical nature of this relationship, and suggests that although armed conflict is commonly assumed to deter new FDI, not all foreign

[45] Harlow international took on the contract to renovate the hotel whilst the Kempinski hotel group won the contract to manage the operations of the hotel.

investors follow the expected path of behaviour of avoiding armed conflicts. In doing so, this chapter examines the effect of external military intervention (EMI) as an independent variable on FDI, and suggests that foreign investment may be likely to occur during armed conflict when independent states intervene with 'boots on the ground', in contrast to the conventional wisdom in the existing literature. In this respect, external military interventions that involve 'boots on the ground' potentially send a 'positive signal' to foreign investors. This can facilitate an improvement in the investment climate by bringing authority and stability to an incendiary economic and political environment which increases investors' confidence as the EMI ensures the protection of property rights, thereby mitigating the risk of asset-seizure or the destruction of property without compensation. The EMI also works towards repairing investors' confidence by restoring the rule of law, assisting in the reconstruction of economic and political institutions, reducing the level of violence and working towards a lasting end to the armed conflict.

4.1.1 Overview of the chapter

The current literature suggests that armed conflict is typically bad for business as it discourages foreign investment, and leads to disinvestment and portfolio substitution. The investigation in this chapter begins by examining whether armed conflict has a negative aggregate effect on FDI. Although the following chapter disaggregates FDI and attempts to establish patterns in FDI, this chapter looks at aggregate rates of FDI to first determine the exact nature of the armed conflict-FDI relationship. This analysis highlights the importance of understanding external military intervention as an influential factor that impacts upon the rate of FDI in armed conflicts.

This chapter is structured as follows. It begins by briefly discussing the main arguments from the literature on the negative effects of armed conflict on FDI and then introduces external military intervention as the main independent variable. The chapter then provides a brief overview of the current limitations to the existing explanations of FDI in armed conflicts and puts forward four hypotheses which are central to the research question. The chapter then offers a rational behind the sample including how some of the limitations are to be addressed. The results are then presented using empirical data with descriptive statistics as the method for determining correlation of FDI in armed conflicts. The chapter then concludes by summarising the results with a discussion on how the results fit within the larger context of the armed conflict-FDI relationship.

4.1.2 Revisiting the literature, the research puzzle and hypotheses

The existing theoretical literature suggests that the onset of armed conflict discourages foreign investors, whilst the deterioration in political stability increases economic uncertainty which cumulates in an investment climate which is not conducive to future FDI. Although some foreign investors still seek market opportunities in armed conflicts, the existing theoretical literature concludes that armed conflict leads to negative FDI as the commercial and non-commercial risks of doing business in armed conflict increases (see Schneider and Rey 1985, Woodward and Rolfe 1993 and Loree and Guisinger 1995).[46]

Although the literature identifies a negative relationship between armed conflict and FDI, numerous cases of foreign investment in armed conflicts suggest that the relationship is not as straight forward as existing works have tended to assume. For

[46] These risks include asset destruction (including asset loss and theft through corruption), domestic demand shocks and abrupt policy shifts. These involve the destruction and disruption of production facilities and supply lines; contractions in domestic markets as population flee to safer areas and changes in government policy which leads to expropriation and nationalisation of investments. These risks lead to armed conflicts suffering from the loss of much needed international capital as foreign investors disinvest, engage in portfolio substitution or relocate their investments elsewhere.

instance, the explanations for cases which deviate from the conventional wisdom rely on three main perspectives (discussed further below) which offer a partial explanation on the occurrence of FDI, but are insufficient to explain all forms of FDI in armed conflicts. In contrast, the research in this thesis suggests that external military intervention can sometimes play an important role in determining whether countries involved in armed conflicts continue to attract FDI.

The foundation of this variable lies with the limited number of explanations that currently exists in the literature on why foreign investors locate to armed conflicts, and where an attempt has been made the explanations have concentrated at three particular perspectives. The first perspective looks at the behaviour of foreign investors in particular at their heterogeneous nature (see Mihalache 2011) and strategic behaviour. This perspective argues that FDI in armed conflicts is an irregular practice which cannot be explained as each investment is different in size and nature, whilst foreign investors perceive conflict affected risks differently. In terms of strategic behaviour, some forms of investment in armed conflicts can be explained by the competitiveness of foreign investors who attempt to benefit from first mover advantage (see Patey 2006) or investors who reduce their exposure to conflict affected risks through adopting strategies which safeguard their investments such as taking out political risk insurance or engaging in collaborative agreements with local companies (see Berman 2000).

The second perspective is derived from looking at sector level FDI including the dichotomy between investments in the natural resource and non-resource sectors. Armed conflict leads to market opportunities but this is specific to certain types of sectors, in particular to the natural resource sectors and sectors which are less capital intense (see MIGA 2010). And the final perspective is grounded in conflict dynamics including conflict intensity. This perspective places significant emphasis on conflict

intensity as a representation of risk with high-intensity armed conflict possessing greater risk to FDI. This suggests that foreign investors are prepared to invest in armed conflicts providing that the intensity is low with high-intensity armed conflicts discouraging FDI (see Berman 2000).[47]

Although the three perspectives offer a useful explanation on why foreign investments are still located in armed conflicts, numerous cases have emerged which show a greater distribution of FDI which fall outside the boundaries of these perspectives and indicate the need for an alternative explanation. For example, if foreign investors are heterogeneous and investment strategies are designed to reflect the risks viewed by each investor differently, this cannot explain cases where there is a broad pattern of positive FDI flows during armed conflict. Likewise, while sector level perspectives highlight the unique characteristics of investment in natural resources, this cannot explain greater levels of FDI in non-resource sectors. Finally, the assumption that foreign investors will only deviate from expected behaviour in cases of low-intensity armed conflict cannot account for the positive rates of FDI flows sometimes found in high-intensity armed conflicts.

The shortcomings of these existing explanations are illustrated by the international investments in the Al-Rasheed hotel in Baghdad, which points to the complexity of the armed conflict-FDI relationship. This example challenges the assumptions of each of these perspectives. First, this investment example was part of a collection of investments in Baghdad, and not an anomaly; second, the investment was in the hotel sector, which is traditionally capital intensive and is assumed to be highly vulnerable to

[47] This is based on the assumption that low-intensity armed conflicts are fought by armed groups who offer only limited offensive capabilities which only dents foreign investors' confidence without having a detrimental effect on the investment climate. As they offer limited offensive capabilities, they are easily confined to remote parts of the country with very little spill-over in commercial and investment intensive areas. If the intensity increases spill-over becomes more likely which increases the risk to the investment.

conflict affected risks; and finally, the investment flowed into a country involved in high-intensity armed conflict.

Based upon this research design this chapter has developed four hypotheses which contribute towards the main research question: *Why do countries involved in internal armed conflict continue to attract FDI?*

H1*: Armed conflicts do not discourage all foreign investors, despite the increased commercial and non-commercial risks.*

H2*: High-intensity armed conflicts do not have a uniform negative effect on foreign investment.*

H3*: External military intervention (EMI) leads to increased FDI in high-intensity armed conflicts.*

H4*: External military intervention (EMI) increases FDI in high-intensity armed conflicts without reducing conflict intensity.*

4.2 The sample

This chapter uses empirical data of a large-*N* sample with descriptive statistics as a method of determining correlation of FDI in armed conflicts. In doing so, it brings together economic, external military intervention and armed conflict data in order to answer the research question: *Why do countries involved in internal armed conflict continue to attract FDI?* As this chapter uses a large-*N* sample, it is necessary to put together sufficient cases which permit the hypothesised relationship to be observed, as well as dealing with the methodological limitations and challenges presented in an empirical investigation. Chapter 3 has already discussed the limitations most commonly associated with empirical investigations including the problems with obtaining complete

and reliable data, therefore the design of the sample is important in ensuring that the investigation is conducted using the most appropriate data and cases.

The large-*N* sample has been designed with this in mind. Armed conflicts from 1996 until 2010 have been chosen as they offer the most complete and reliable data than any other period. This includes economic data which so often in armed conflicts is missing, limited or unreliable. In addition to this, additional variables have also been chosen to complement the discussion; therefore, the sample needs to ensure that data for these variables is also available. Although the emphasis of this thesis rests on the independent variable of external military intervention (EMI), and through descriptive statistics correlation is determined, incorporating additional variables offers a degree of scrutiny to the discussion, especially as these variables are relevant in the attraction of FDI. Therefore, additional variables have been brought in which include economic (growth), geography (location), political (democracy & government effectiveness), social (human development) and resources (resource endowments).

The design of the sample also requires careful consideration, especially in regards to the type of armed conflicts which are to be analysed. As armed conflicts can be broadly separated into three types from international to interstate and internal (intrastate), their effect on FDI also differs dependent on the level of destruction they cause. All three armed conflicts are destructive; however, unlike internal armed conflicts which have been chosen in this thesis, international armed conflicts are very infrequent and therefore do not offer sufficient cases, whilst interstate armed conflicts are often fought for territorial reasons, therefore their level of destruction is often confined to border areas. Internal armed conflicts are most suited to this thesis as they are the most frequent type of armed conflict and since the end of the Second World War have emerged as the most dominant form of political instability (see Buhaug et al. 2007). This ensures that

the sample is rich in cases.[48] Additionally, internal armed conflicts are also seen as having more severe implications for foreign investors than any other type of armed conflict (see Li 2006) because it is an enclosed armed conflict which is fought within the borders of the state where destruction is concentrated on economic, political and social infrastructure. And as the incompatibility involves the forceful change of government or the seizure of territory, its impact on FDI is seen to be greater than international and interstate armed conflicts.

In addition to the sample design a brief explanation is required on the cases which would be included in the large-*N* sample. Looking at any conflict dataset for the time period of 1996 to 2010 will show a large number of possible cases which could be used in this investigation, however, under close scrutiny not all cases are suitable for analysis as they are either two short in length or suffer from constant breaks in their conflict cycle.

The first criterion considers the length of an armed conflict in order to acknowledge the time-lag often accompanying decisions on foreign investment. This time-lag can only be considered if armed conflicts last for a sufficient duration which captures the immediate short-term effects on FDI and also the long term behaviour of foreign investors. For instance, the start of an armed conflict is perceived to carry significant risks to foreign investors which leads to capital flight or the substitution to alternative destinations, however, the long term perception of an armed conflict changes as foreign investors are better able to manage conflict affected risks which leads to a gradual increase in FDI. Therefore, to fully understand how foreign investors behave it is

[48] According to the Uppsala Conflict Data programme (UCDP) and Peace Research Institute Oslo (PRIO) Armed Conflict Dataset (see Gleditsch et al. 2002), internal armed conflict and internationalized internal armed conflict represent 74 total conflicts from 1996-2010, with interstate conflict representing 3 and international armed conflict 0. The 74 internal and internationalized internal armed conflicts also include armed conflicts which started before 1996 but also featured within the time frame. This also includes countries which were fighting several conflicts at one time, see appendix 4.1 on armed conflict type and trends from 1946-2006.

necessary to include only armed conflicts which have lasted for more than two years as these are better able to illustrate the armed conflict-FDI relationship.[49]

The second criterion focuses on the life cycle of an armed conflict. Typically, during lengthy armed conflicts, it is not unusual to see periods of peace intermixed with periods of armed violence as antagonists often agree to temporary ceasefires or even reach peace deals, which are reneged on later when armed violence between competing groups reinitiates the pre-existing armed conflict. As the nature of this investigation is to understand flows of FDI during armed conflict, it is necessary to eliminate cases which do not have a consistent flow of armed violence or are interrupted by periods of inactivity where ceasefires or peace deals are reached. By eliminating such cases, the investigation could accurately pinpoint how FDI behaves during active armed conflict rather than making any judgements which could be considered to be spurious.[50]

In order to achieve the two criteria identified above, this thesis uses battle related deaths obtained from conflict datasets to measure the start, duration, end and life cycle of an armed conflict. This method has been chosen over using official statements and declarations such as ceasefires as often during armed conflicts, the violence continues long after ceasefires have been agreed.[51] Therefore, conflict datasets which use battle related deaths continue to classify armed conflicts as 'active' even if antagonists have agreed to a ceasefire [providing that armed violence reaches the necessary threshold]. In using this method it is possible that actual data may not acquiesce with official declarations of an armed conflict, however, as this thesis concentrates on identifying

[49] In applying this criterion to the sample, internal armed conflicts which lasted fewer than two years have been eliminated. These include Azerbaijan (2005), Comoros (1997), Central African Republic (2002, 2006 & 2009) Djibouti (1999), Georgia (2004 & 2008), Haiti (2004), Lesotho (1998), Macedonia (2001), Mauritania (2010), Mexico (1996), Nigeria (2004 & 2009) Papua New Guinea (1996), Tajikistan (1996, 1998 & 2010) and the United Kingdom (1998). Yemen's conflict in 2009/2010 is also excluded from the sample due to missing economic data.

[50] In applying this criterion to the sample, internal armed conflicts which have been eliminated from the investigation include Eretria, Niger and Pakistan.

[51] A good example of how armed violence continues long after ceasefires or end of hostilities have been announced is the US declaration in 2003 that the war in Iraq had ended even though armed violence continued long after US forces left Iraq in 2011.

how foreign investors react to ongoing armed conflicts, battle related deaths offers a natural fit in the analysis of how continued armed violence affects FDI.

4.3 The findings

The large-*N* sample consists of 35 internal armed conflicts; 18 from Africa, 2 from the Americas, 9 from Asia, 2 from Europe and 4 from the Middle East.[52] Rather than grouping them under region, they are grouped under economic development as categorised by the United Nations Conference on Trade and Development (UNCTAD) (see appendix 4.2) – from which FDI data is taken – as they provide a better level of analysis when comparing country level FDI against averages for its level of economic development. Under these groupings, the majority of armed conflicts have occurred in fragile developing countries (31) – which is consistent with Murdoch and Sandler's (2002a) assertion that developing countries tend to suffer from internal armed conflict – with 3 armed conflicts occurring in transition economies and 1 in developed economies (Asia). Under the developing countries group, armed conflicts are further dichotomised by their level of income, with 1 armed conflict falling in the high-income category, 9 in the middle-income category and 21 in the low-income category.

With 35 armed conflicts representing 5 regions and 3 different levels of economic development, the sample provides a rich birth of diverse cases with each armed conflict possessing unique characteristics in terms of economic, political and social as well as characteristics related to their individual armed conflicts. The latter in particular, also provides a degree of variance in terms of intensity and conflict duration and data for this is taken from UCDP/PRIO Armed Conflict dataset (see Gleditsch 2002, and Themner and Wallensteen 2011). For conflict duration, 10 armed conflicts provide 15 years of

[52] The regional classification for each armed conflict is taken from the UCDP/PRIO Armed Conflict dataset codebook (see Gleditsch, 2002 and Themner and Wallensteen 2011).

analysis with each armed conflict running through the 15 year time frame from 1996 to 2010. A further 7 armed conflicts contribute between 10 to 14 years to the analysis; 6 provide between 7 to 9 conflict years with the remainder of the sample consisting of relatively short armed conflicts (12) which provide between 2 to 5 conflict years. In total, the sample consists of 322 conflict years with a mean value of 9.2 years per each armed conflict (see appendix 4.4). Dichotomising the sample by economic development and duration offers a degree of variance to the analysis as it allows this thesis to identify whether economic development and the duration of an armed conflict affects FDI.

4.3.1 Armed conflict and positive inward and net FDI

The results indicate that in general countries affected by armed conflicts continue to attract FDI although in some cases armed conflict does have a negative effect on FDI. The sample shows that out of 35 armed conflicts, every case within the sample was able to attract FDI for most of their conflict years and although some armed conflicts did see FDI fall to almost zero per cent of their GDP and in some cases FDI was negative at some point during their armed conflicts, FDI for the remainder of their armed conflicts remained positive.[53] Out of a total of 322 years of armed conflict, 297 years registered positive FDI with 15 years registering as negative and 10 years where FDI was zero (see appendix 4.4). This suggested that the negative effects of armed conflict on FDI were not universal throughout the sample despite the absence of political stability.

When looking at net FDI (% of GDP),[54] the results indicated that only in some cases did disinvestment occur as for the majority of the cases, net FDI remained positive.[55] Out of 317 conflict years, 298 conflict years registered positive net FDI with 12 conflict years

[53] FDI as a percentage of GDP is taken from the United Nations Conference on Trade and Development (UNCTAD) dataset (http://unctad.org/en/Pages/Home.aspx).
[54] Data on the net FDI as a percentage of GDP is taken from the World Bank Databank (http://data.worldbank.org/).
[55] According to the United Nations Conference on Trade and Development (UNCTAD), FDI with a negative sign indicates that at least one of the three components of FDI (equity capital, reinvested earnings or intra-company loans) is negative and not offset by the positive amounts of the remaining components. These are instances of reverse investment or disinvestment.

registering negative and 7 years registering zero net FDI. This suggested that although foreign investment continued to flow into armed conflicts, there was little evidence to show that disinvestment occurred as for most of the conflict years net FDI remained positive (see appendix 4.5).[56]

Although the results confirmed on two counts that: 1) FDI continued to flow during armed conflict and; 2) that foreign investors did not engage in disinvestment, a degree of caution needs to be applied to these results due to the nature of the method used in this investigation. The investigation used the data in a non-figurative sense by only looking at movements in FDI flows during armed conflict without taking into consideration external factors which are often discussed to be important in the attraction and retention of FDI. Although these factors are important to the thesis and are discussed later in the chapter, this stage of the investigation only concentrated on how foreign investors reacted to the onset of armed conflict with the assumption that these factors would also be negatively affected by armed conflict. Based upon this assumption, the above results intend to give only a general impression on the armed conflict-FDI relationship before a more thorough and robust examination.

In addition, the results were also heavily reliant on formal and aggregate data. Formal data on FDI was used to measure FDI flows which excluded informal FDI which is often associated with armed conflicts (see Looney 2006 and Driffield et al. 2013). During armed conflict, informal economies emerge from the breakdown of government institutions which leads to trade and investment – both domestic and international – taking place outside of the legal parameters and therefore its exclusion from official data. Although this is a problem when measuring economic activity during armed conflict, over recent years an attempt has been made to encourage multinational

[56] The number of conflict years for net FDI has been reduced by 5 due to missing data for Afghanistan between 1996 and 2000 (see appendix 4.5).

corporations (MNCs) against operating informally in fragile states and conflict zones. For instance, the Organisation for Economic Co-operation and Development (OECD) has created guidelines which advise all member states to govern the behaviour of their MNCs. As these guidelines have strengthened and enforced, there has been a reduction in informal economic activity in fragile states and conflict zones (see Černič 2008).[57] Therefore, bearing this in mind, there is significant confidence that official FDI data used in this investigation is an accurate reflection of FDI flows into armed conflicts.

The results also used aggregate FDI and armed conflict data and continue to do so for the remainder of this chapter. The purpose of using aggregate data was to develop a general impression of foreign investment during armed conflict and to show that contrary to the existing literature a counter intuitive relationship exists. Although the use of aggregate FDI showed that foreign investors are not risk-adverse, it raised several questions on how FDI related factors such as investment strategy, origin, location of the investment and sector influence FDI in conflict zones. In addition, the use of aggregate data on armed conflict also raised some questions. The data used in the results did not differentiate between armed conflicts in the sample and presented them as being homogenous even though armed conflicts tend to be different in terms of their cause, intensity, spatiality and nature. This suggested that possible influences to foreign investors could come from conflict dynamics which requires further investigation. The questions raised in this section are further explored in chapter 5.

4.3.1.1 Developed economies

The individual analysis of each case in the sample provided a better understanding on complexity of the armed conflict-FDI relationship. Segmenting the analysis by

[57] These guidelines are the only corporate responsibility instruments formally adopted by states and remain the most prominent interstate document on various aspects of corporate responsibility and the role of international investment (see also the United Nations initiative on 'Business for Peace: The Private Sector and Conflict).

economic development showed that FDI flows in more developed economies were least affected by armed conflict with less developing countries showing more pronounced negative effects. Starting with Israel which is the most developed country in the sample, trends in FDI flows suggested that its armed conflict in the occupied territories had not deterred foreign investors or led to disinvestment. Throughout the time period Israel's FDI as a percentage of its GDP was at, or, above 2% per annum and outperformed the average for its economic group.[58]

Figure 4a. Israel's FDI (% of GDP) compared to UNCTAD economic group (1996-2010)

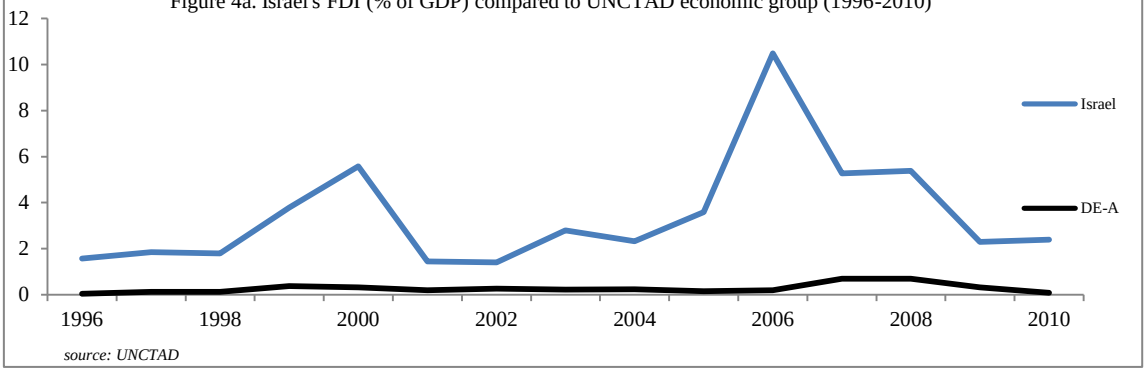
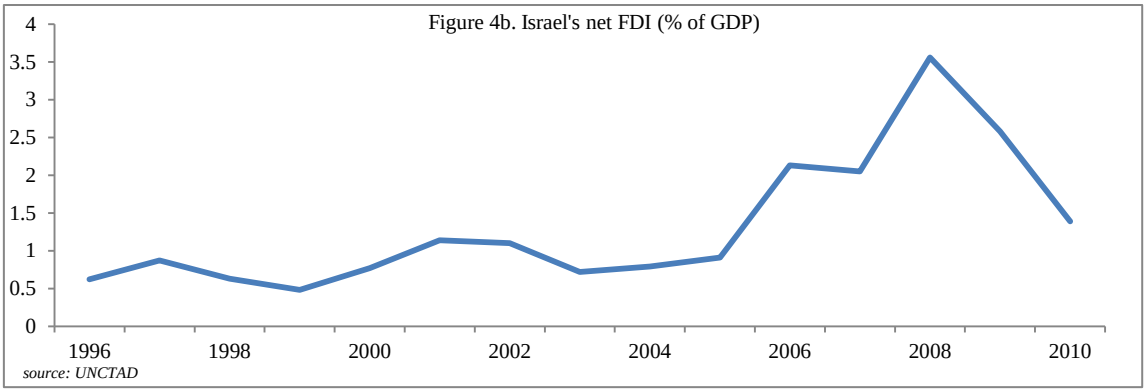


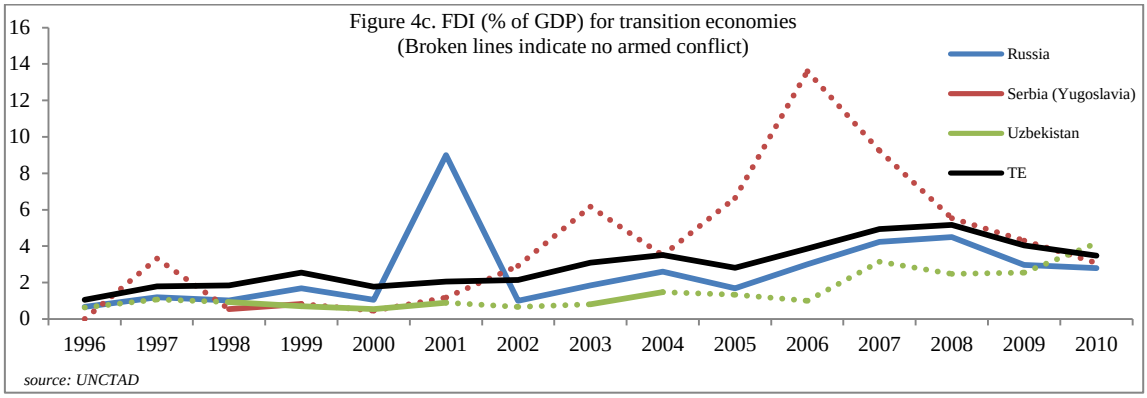
Figure 4b. Israel's net FDI (% of GDP)



A similar trend was also evident in the transition economies group within the sample. In this group Russia, Serbia and Uzbekistan registered positive FDI although this was just under the average FDI of the transition economies group. Russia's armed conflict in Chechnya which ran throughout the time frame showed positive FDI and positive net FDI for each of its conflict years with a gradual incline during the start of the time

[58] Israel's armed conflict in the occupied territories of Palestine is classified as an internal armed conflict according to the UCDP/PRIO Armed Conflict Dataset (see, Gleditsch et al. 2002 and Themnér and Wallensteen 2011).

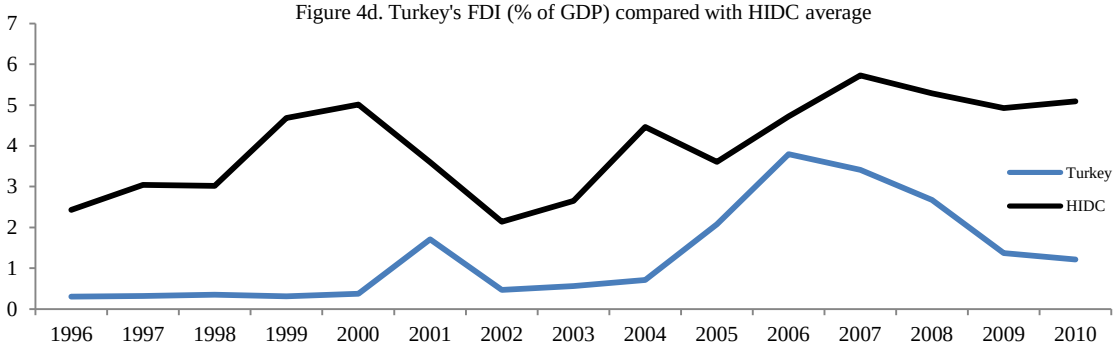
period; Serbia's armed conflict in the Balkans (1998 & 1999) which offered two years of armed conflict and Uzbekistan's armed conflict against the Islamic Movement of Uzbekistan (IMU) which offered 3 years of armed conflict (1999, 2000 & 2004) also registered positive FDI, however, there were mild falls in its FDI compared to pre and post-conflict FDI levels.[59]



Similar FDI flows were also observed in the developing countries group. Turkey which is the most developed country in this group and categorised as high-income developing country (HIDC) provided 15 years of armed conflict and during this time showed no evidence that its armed conflict affected its FDI. Turkey's armed struggle against Kurdish separatist groups including the Kurdistan Workers' Party (PKK) did not lead to FDI falling as during this time its FDI and net FDI remained consistent with pre-conflict levels, although its FDI was below the average for its economic group.

[59] In the case of Uzbekistan, there were other factors which played a major role in its decreased FDI. During this period Uzbekistan became a pariah in the international financial community, after introducing a multiple exchange rate regime in 1997 against the strong advice from the International Monetary Fund (IMF). This led to the IMF cancelling its loan that same year and withdrawing its Resident Representative from the country which sent a damaging signal to foreign investors (see Brome, 2010, pp. 179-180.

Figure 4d. Turkey's FDI (% of GDP) compared with HIDC average



source: UNCTAD

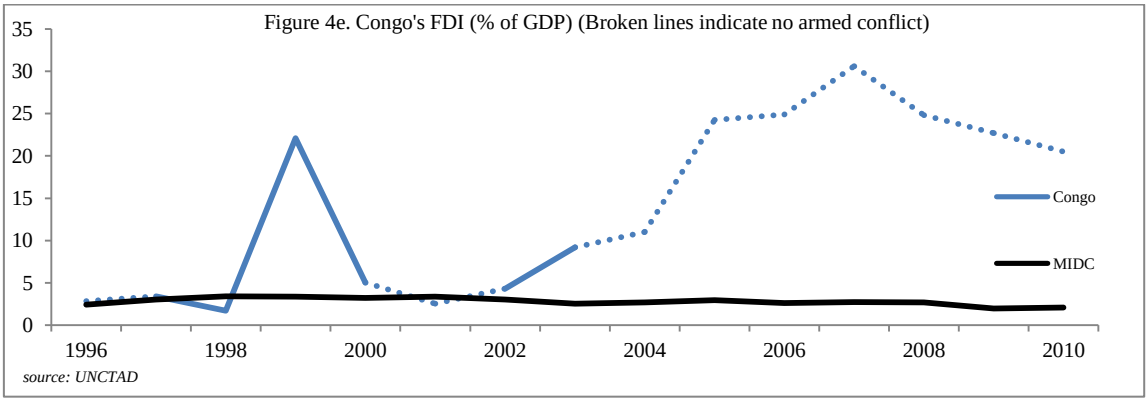
Although the results from the developed, transition and high-income developing economies showed that FDI remained positive during armed conflict, the data suggested that with the exception of Israel, Russia and Turkey, FDI fell during armed conflict. The results indicated that although armed conflict didn't reduce FDI to negative levels or lead to negative net FDI, it did lead to reduced rates of FDI which would have been higher in peace time. Although this was not consistent with FDI flows in Israel, Russia and Turkey, and these conflicts appeared to show no negative effects, higher rates of FDI could have been attributable to the nature of their armed conflicts. Israel's armed conflict was concentrated in the occupied territories and therefore did not affect investments into proper Israel, whilst Russia's armed conflict was located in Chechnya which is practically a separate enclave of Russia and therefore did not concern foreign investors in Moscow. Although Turkey's armed conflict was located within its borders, it was confined to its southern border region without affecting its more commercial and investment intensive areas. This containment can therefore explain why FDI flows were higher in these countries compared to Serbia which had seen a more widespread armed conflict.

4.3.1.2 Middle-income developing countries

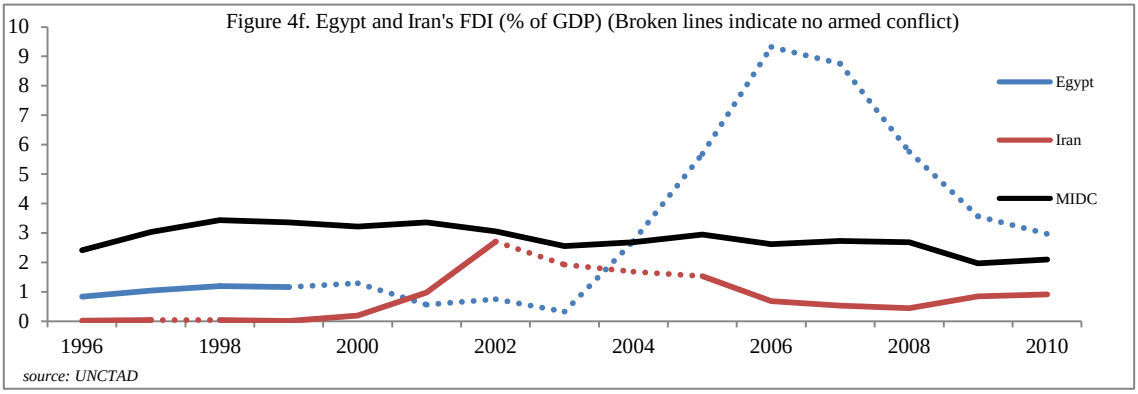
The complex nature of the armed conflict-FDI relationship was further illustrated in the middle-income developing countries group (MIDC) where the data didn't support the

theoretical arguments in the literature. In this group of armed conflicts [which included Algeria, Colombia, Congo, Egypt, Iran, Peru, Philippines, Sri Lanka and Thailand], Algeria, Colombia, Philippines, Sri Lanka and Thailand followed a similar pattern to Israel, Russia and Turkey, where FDI remained positive with no disruption in their FDI flows, however, FDI did drop in Congo, Egypt and Iran but this was short-lived as FDI either returned to normal with slight increases or peaked above pre-conflict levels.[60] In these cases, it was expected that the immediate negative effect would carry through the remainder of their conflict years, but the trend line suggested that once FDI recovered to pre-conflict levels there was a period of increased FDI as was demonstrated in Congo's FDI in 1998. This indicated that foreign investor's perception of armed conflict was integral to FDI flows with the short-term perception suggesting that the investment carried significant risks and therefore led to decreased rates of FDI, and the long term perception suggesting a better management of risk which led to increased rates of FDI.

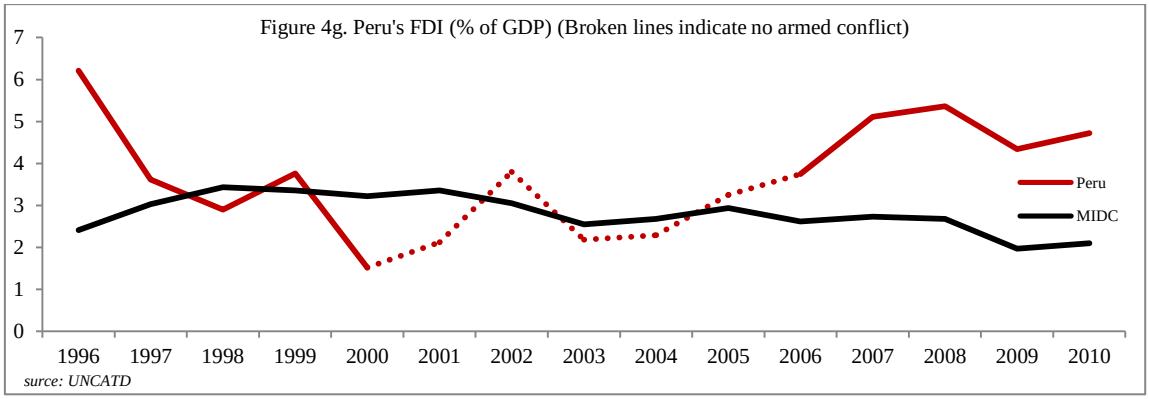
Figure 4e. Congo's FDI (% of GDP) (Broken lines indicate no armed conflict)



[60] In the sample Congo offers 4 years of armed conflict, Egypt 3 years and Iran 11 years. Years of no armed conflict are either post-conflict or intervening years of peace. Congo's FDI since the end of its armed conflict in 2002 for 2003-2010 were; 9.19, 11.03, 24.23, 24.9, 30.6, 24.82, 22.71 and 20.5% of GDP.



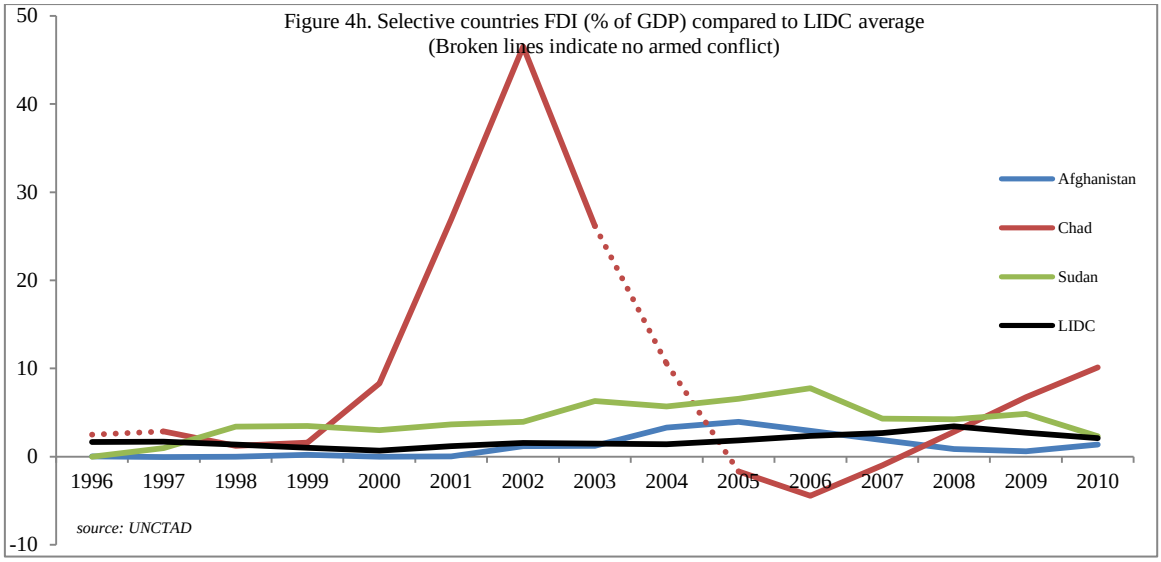
Amongst the sample of the middle-income developing countries, Peru emerged as an interesting case which reflected the complex relationship between armed conflict and FDI. Peru's armed conflict against the Maoist guerrilla insurgents of the Shining Path (Sendero Lumineso) was fought in two periods separated by a period of relative peace. In the first period (1996-2000) Peru's FDI decreased annually eventually settling below the average for its economic group, but in the second period (2006-2010) Peru's FDI increased almost every year to levels above peace-time (2000-2006), and above the MIDC group average even though FDI flows for the MIDC group was falling. The data here pointed to two key relationships: one in which armed conflict had a negative effect on FDI and the other where FDI increased during armed conflict.



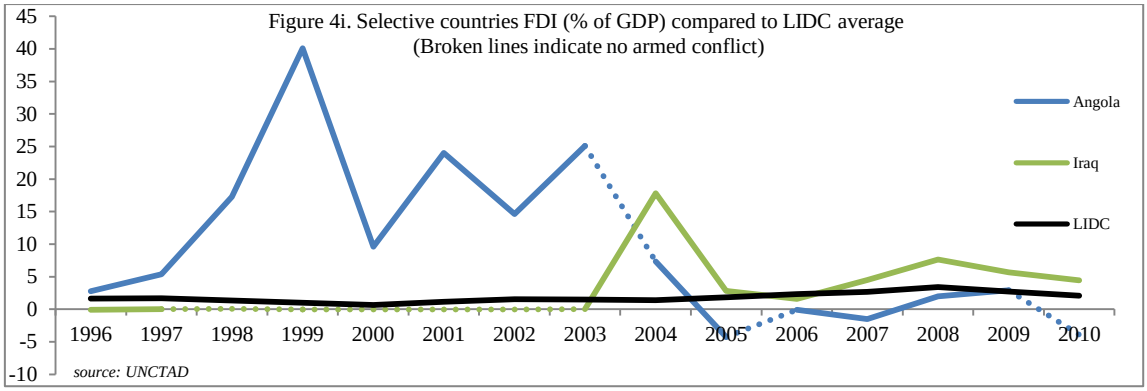
4.3.1.3 Low-income developing countries

Although some evidence pointed towards reduced FDI flows during armed conflict in the MIDC group, in the low-income developing countries group (LIDC) the negative effects of armed conflict were more pronounced. In this sample of countries just under 50% of cases registered either zero or negative rates in FDI with some cases showing armed conflict to have long term negative effects on the investment climate with evidence pointing to spill-over effects into the post-conflict period. However, despite these negative effects, in most cases FDI returned to normal or increased.

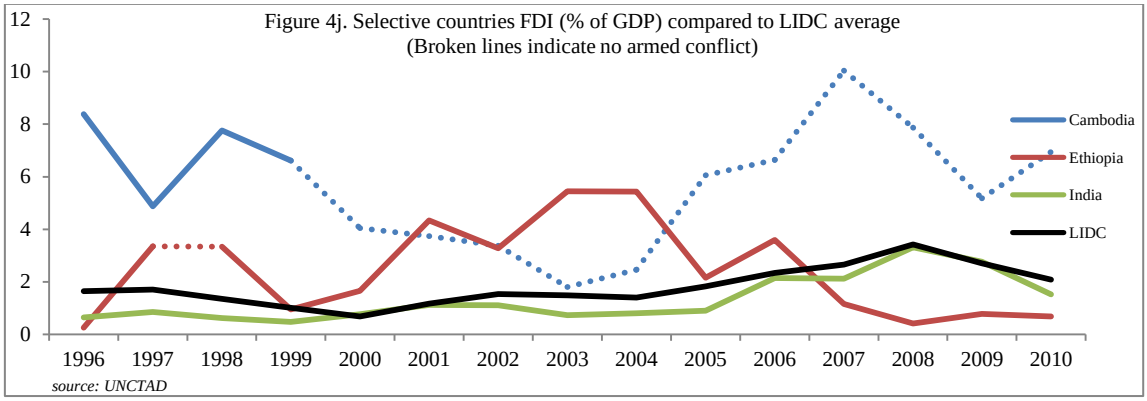
Within the LIDC group three noteworthy trends emerged which went against the intuitive theoretical perspectives. The first trend suggested that armed conflict had a short term negative effect on foreign investment where FDI flows dropped below pre-conflict FDI, but as the conflict became protracted foreign investment recovered to, or, increased above pre-conflict FDI. This was supported by FDI trends in Afghanistan, Chad and Sudan. In Afghanistan, FDI fell immediately at the start of its armed conflict which led to negative rates of FDI and net FDI, but this effect was short-lived as FDI returned to positive; in Chad FDI fell for three consecutive years but then increased significantly despite no respite in its level of violence and; Sudan, where FDI fell leading to negative net FDI but then increased above its pre-conflict FDI and above the average for the LIDC average.



The second trend followed a similar pattern to that observed in the more developed countries where the start of an armed conflict had a positive effect on foreign investment. In this cluster of cases which included Angola and Iraq, higher rates of foreign investment were recorded immediately after he start of armed conflict with pre-conflict FDI running at very low rates. For instance, Iraq's foreign investment was flat-lining just above 0.1% of its GDP but soon after the start of hostilities in 2003 foreign investment accelerated to 15% of its GDP before averaging 4% for the remainder of its conflict years and outperforming the LIDC average. Angola followed a similar pattern as its FDI also accelerated once its armed conflict started, with FDI at 40% of its GDP in 1999 and fluctuating between 10 to 25% for the next few years. Although the data showed FDI to fall in 2003, this occurred during a period of relative peace which was counter intuitive and unexpected.



And the final trend in the low-income developing countries group showed armed conflict to have no great shocks on foreign investment levels, although there were some reductions in the rate of FDI. This included armed conflict in Cambodia, Ethiopia and India where any fall in FDI were evened out by subsequent rises in investment levels. For Instance, FDI levels in Cambodia dropped at the start of its armed conflict, but there was no lasting effect as its investment levels returned to its pre-conflict high and remained above the LIDC average. Ethiopia's FDI throughout its armed conflict was higher than its pre-conflict FDI and for most of its time period was above the LIDC average; whilst India's FDI mirrored the LIDC average with some mild drops in its FDI flows.[61]



[61] In the time frame, Cambodia's armed conflict provided 3 years of armed conflict (1996-1998), Ethiopia with 14 years (1996, 1998-2010) and India with 15 years (1996-2010) (see appendix 4.3). Within the less income developing countries group other noticeable trends included FDI improving in the post-conflict period (Cote d'Ivoire, Democratic Republic of Congo, Guinea, Guinea-Bissau, Liberia, Mali, Rwanda, Senegal and Sierra Leone) and FDI not recovering post-conflict (Burundi).

4.3.1.4 Varied relationships between armed conflict and FDI

From the results above it was clear that a varied relationship existed between armed conflict and FDI which rendered the relationship far more complex than simply positive or negative. The data suggested that despite some cases supporting the theoretical perspectives that armed conflict negatively affects foreign investment; in most cases the effect was either short-lived, neutral or led to increased flows of FDI. The data also revealed that dichotomising the sample in terms of economic development helped to identify that although the negative effects of armed conflict on foreign investment were more pronounced in middle and low-income developing countries compared to developed, transition and high-income developing countries, increased FDI flows in the least developed countries rendered income levels and economic development insignificant in attracting FDI.

Figure 4k. Decreases in FDI (% of GDP) in the first year after armed conflict dichotomised by economic group

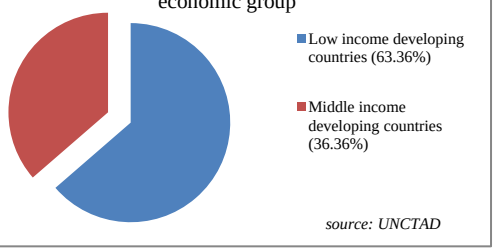
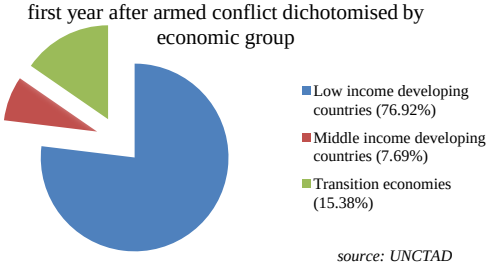


Figure 4l. Increases in FDI (% of GDP) in the first year after armed conflict dichotomised by economic group



More was ascertained by looking at the bottom two economic groups which revealed some interesting relationships with the obvious supporting the theoretical arguments that political stability is a key determinant in attracting and retaining foreign investments (see Schneider and Rey 1985; Woodward and Rolfe 1993; and Loree and Guisinger 1995). This was supported by the data from the LIDC group which showed that 50% of the sample registered negative rates of FDI at some point during their armed conflicts with some evidence pointing to capital flight. Although this was expected, the data also revealed several significant relationships which went against the

commonly held assumptions. The first significant relationship suggested that armed conflict only had a short-lived negative effect on foreign investments as data from Congo, Egypt and Iran suggested that FDI often recovered after the initial shock, whilst data from Afghanistan, Chad and Sudan pointed towards a possible link between FDI and protracted armed conflicts. This suggested that the normalisation of FDI was time-dependent rather than being dependent on the end of an armed conflict as foreign investors would return once they were confident that they could better manage conflict affected risks.

The second significant relationship suggested armed conflict to increase FDI which indicated that armed conflict generated market opportunities for foreign investors by transforming the investment climate through removing obstacles which were unfavourable for foreign investment. This coincided with the 'war renewal school' of thought who argue that armed conflict plays a positive role in transforming economies as it removes obstacles which prohibit economic development (see Organski and Kugler 1980; and Olson 1982). This was supported by data from Angola, Iraq and Peru where FDI flows were higher during armed conflict than before and outperformed their economic group average. In the case of Iraq, economic sanctions had prevented FDI, which were removed once its armed conflict started. Although the higher rates in FDI flows stemmed from the removal of its sanctions, the war was necessary in order to remove a regime which had obstructed its economic development. This fits in with the 'war renewal school' which argues that war is necessary in order to transform economic development. And the final significant trend observed in the analysis included cases where FDI followed a similar pattern to FDI in the more economically developed groups (developed, transition and high-income developing countries) where armed conflict had some impact on the investment climate but FDI remained steady and in line

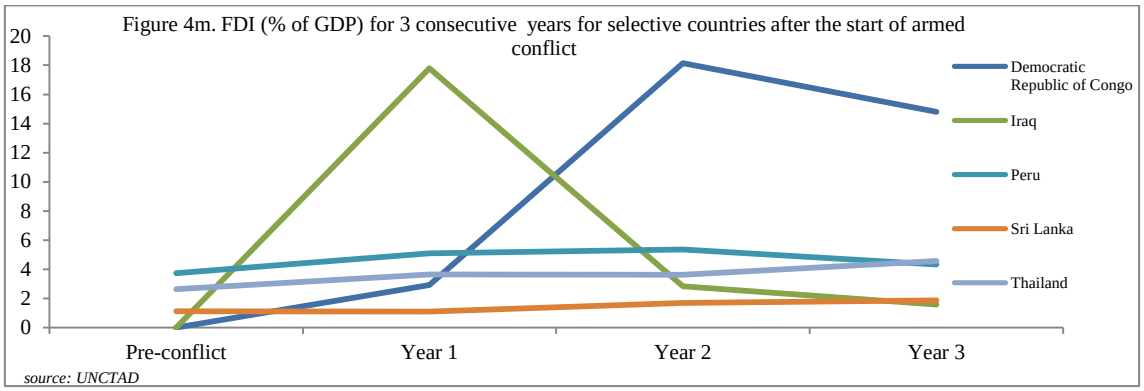
with pre-conflict FDI. This included FDI in Cambodia, Ethiopia and India where any fall in investment levels were evened out by subsequent rises.

4.3.2 Armed conflict and long term FDI

Amongst the relationships that were identified in the previous section, one relationship stood out which required further examination. This relationship revealed that the negative effects of armed conflict on FDI were short lived as FDI recovered fairly quickly after the initial shock, but some cases emerged to show that this was not universal throughout the sample as the negativity surrounding armed conflict lasted throughout the duration of some of the cases. The intuitive assumption should hold that in the event of an armed conflict, rates of FDI should fall as foreign investors select alternative destinations while existing investors disinvest, thus leading to a depreciation in the investment climate until after the armed conflict has come to an end. The data suggested that two trends were applicable to the sample – one in which armed conflict was bad for business and therefore led to falling rates in FDI and the other where armed conflict had relatively no effect as FDI either remained steady in line with, or, increased above pre-conflict levels. From these two trends a key pattern emerged on the direction of FDI flows in armed conflict which suggested that FDI would remain steady in line with, or, exceed above pre-conflict FDI providing that the initial shock from armed conflict did not lead to FDI falling in the first year.

This pattern was supported by a large number of cases which included the Democratic Republic of Congo, Iraq, Peru, Sri Lanka and Thailand where FDI trends would remain on an upward trajectory throughout their armed conflicts. Looking at only the first three years after the start of an armed conflict, the data showed that FDI increased by a minimum of at least 1 percentage point GDP from pre-conflict FDI levels with several

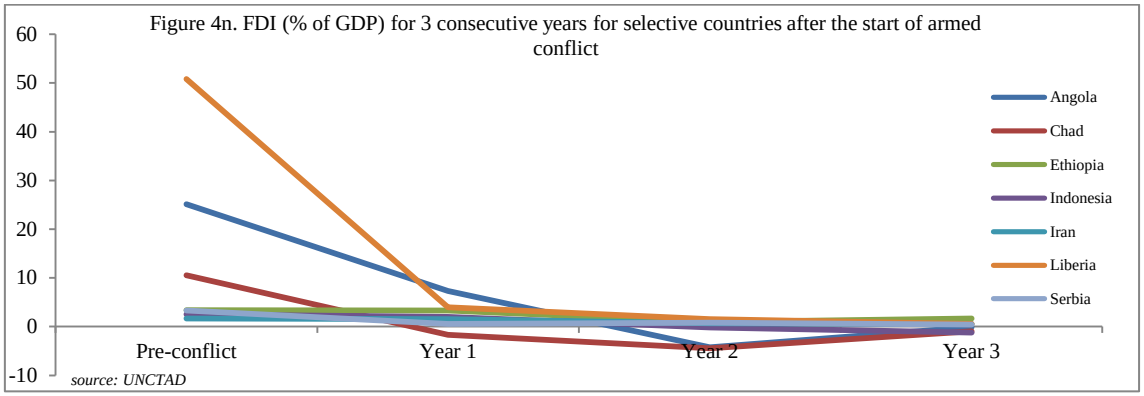
cases recording far greater increases. For instance, Peru managed to prevent any falls in FDI immediately after the start of its armed conflict and by its third year had registered an increase of 1 percentage point of its GDP; whilst FDI in the Democratic Republic of Congo reached 15% of its GDP in its third year after registering 0% during pre-conflict and 3% in its first year of armed conflict. The trend in these cases pointed towards several factors including foreign investors' ability in managing conflict affected risks, and greater confidence in the government in preventing the escalation in armed violence.[62]



In response to this, a number of cases also emerged with showed an opposite effect where any falls in FDI in the first year continued a cycle of depreciation in the investment climate. This pointed towards foreign investors' averseness towards conflict affected risks and possible lack of confidence in the government's ability to contain armed violence. In these cases when FDI fell after the start of armed conflict, the trend continued into a downward trajectory with some cases registering negative flows of FDI which resulted in net disinvestment, whilst others, although still able to maintain positive FDI, saw FDI below pre-conflict levels. This included FDI in Angola, Chad and Indonesia where FDI fell into negative after the first year of armed conflict, and

[62] Other countries which were in the sample and also showed an increase in FDI immediately after the start of their armed conflicts were Congo and Rwanda.

Ethiopia, Iran and Liberia where FDI fell and continued to fall during the next three years but remained at a positive level.[63]



4.3.3 Conflict intensity and FDI

From the data presented in the earlier sections, it has become clear that armed conflict does not have a universal effect on foreign investment with positive and negative rates in FDI registered across the sample. From these diverse relationships, a key factor which could explain why foreign investment tends to be higher in some cases, whilst falling in others is conflict intensity. The existing literature suggests that conflict intensity is a key determinant of FDI and although political stability is fundamental to a healthy investment climate, the loss in political stability can be tolerated if armed conflicts are fought at low-intensity. This is premised on the argument that low-intensity armed conflicts possess limited risks to the investment as armed violence can be contained to remote parts of the country with little spill-over into commercial and investment intensive areas (see Berman 2000). Alternatively, high-intensity armed conflicts are far more detrimental to FDI as its impact is wide reaching with spill-over in commercial and investment intensive areas more common. Its wide reaching

[63] Other cases which registered reductions in FDI immediately after the start of their armed conflicts were Cote d'Ivoire, Guinea, Guinea-Bissau, Mali, Senegal and Uzbekistan.

properties therefore affects foreign investors directly as it leads to asset destruction and disrupts domestic markets.

The data showed that high-intensity armed conflict had no effect on FDI flows as countries which were fought with high-intensity (war) were equally as likely to attract foreign investment as countries which were fought with low-intensity (minor) (see appendix 4.10).[64] This supported the earlier conclusion that not all foreign investors are risk-adverse with other factors being significant in the attraction of FDI. From the large-*N* sample, FDI flows were analysed in 19 cases where armed conflict was fought with high-intensity for at least a minimum of one year. These cases provided 107 high-intensity conflict years with the remainder (89) coded as low-intensity (see appendix 4.10).[65]

From the data is was evident that conflict intensity was not significant in the attraction of foreign investment as high rates of FDI and positive net FDI was observed in the sample. From the 107 high-intensity conflict years, zero and negative rates of FDI were only observed in 6 conflict years with only 1 year registering negative net FDI, whilst the remaining conflict years registered positive FDI (see figure 4.11). The data therefore suggested that high-intensity armed conflict did not lead to falling rates in FDI or disinvestment despite Berman's assertion that the positive distribution of foreign investment can be explained by low-intensity armed conflict (2000).[66]

[64] The intensity of an armed conflict was measured through counting battle related deaths and assigning a minimum threshold which distinguished between high-intensity (war) and low-intensity (minor) armed conflicts. In the UCDP/PRIO Armed Conflict dataset (see Gleditsch, 2002 and Themner and Wallensteen 2011) a high-intensity armed conflict is coded once 1,000 battle related deaths have been recorded in a given year, with anything less coded as being low-intensity. As conflict intensity is measured on a yearly basis, it takes into account any fluctuations in conflict intensity especially in durational armed conflicts which are often fought with various degrees of armed violence. This yearly measurement in this investigation is useful as it allows this thesis to track changes in FDI in accordance with changes in conflict intensity.

[65] There were 19 cases which could be analysed for conflict intensity. These included: Russia & Serbia (transition), Turkey (HIDC), Algeria, Colombia, Congo & Sri Lanka (MIDC) and Afghanistan, Angola, Burundi, Chad, Democratic Republic of Congo, India, Iraq, Liberia, Rwanda, Sierra Leon, Sudan and Uganda (LIDC).

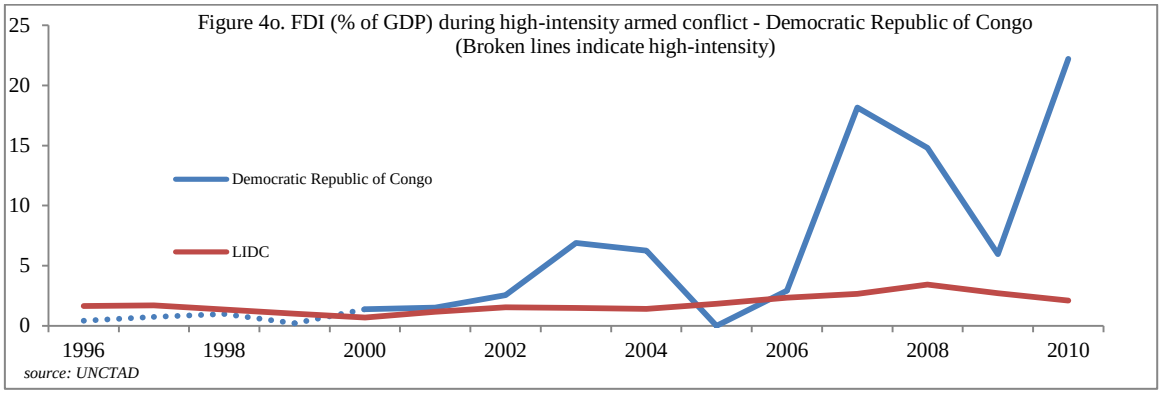
[66] There were only 102 conflict years for net FDI as data for Afghanistan's net FDI is missing from 1996 until 2000.

Dichotomising the sample by level of economic development also indicated that conflict intensity had limited negative effects on FDI on the level of development as some cases from each of the different economic groups showed FDI to increase during high-intensity armed conflict. Israel (developed economies - Asia), Russia (transition), Turkey (high-income developing) and Algeria, Colombia, Congo and Sri Lanka (middle-income developing) showed positive rates of FDI during their most intense periods, although these countries had a relatively good level of economic development. As it was common for low-income countries to struggle to compete for foreign investment, it was expected that increased intensity in their armed conflicts would only exacerbate their inability to attract FDI; however, the data didn't support this contention. Although it was noticeable in some cases that increased conflict intensity led to shocks on FDI, the majority of the cases in this group seemed to show conflict intensity to have no significant negative effect on FDI.

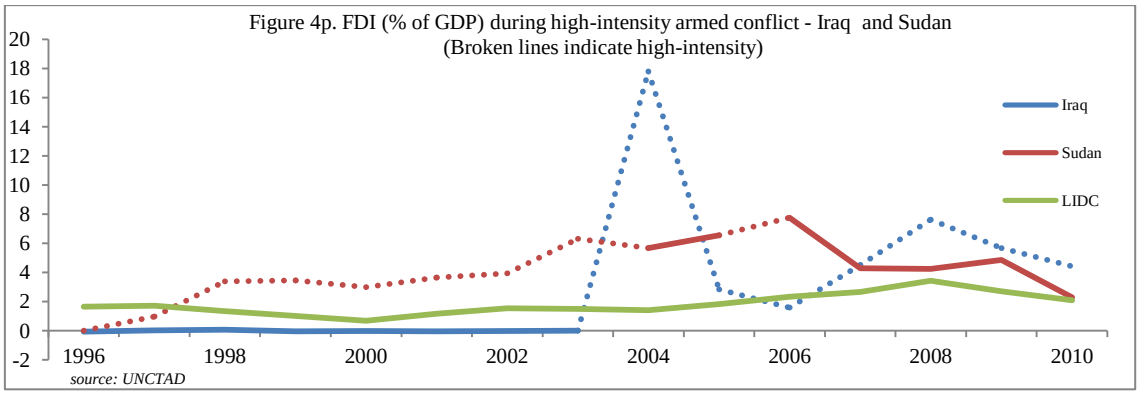
From the LIDC group, the cases showing the relationship between armed conflict and FDI could be separated into three groups. The first included cases where the relationship was intuitive and supported Berman's (2000) assertion that conflict intensity can explain the distribution of FDI; the second group consisted of cases which showed a counter intuitive relationship where FDI flows were higher when conflict intensity increased; and the third group included cases where there was no explainable effect.

Focusing the analysis on the first trend showed that out of 12 cases, 4 cases offered clear evidence in support of the intuitive relationship between conflict intensity and foreign investment. These cases included Chad (2006), Democratic Republic of Congo (1996-2000), India (2000-2005) and Sierra Leone (1998 & 1999) with the data pointing towards higher rates of FDI associated with lower levels of conflict intensity. The data also showed how FDI flows would fall when the intensity of an armed conflict

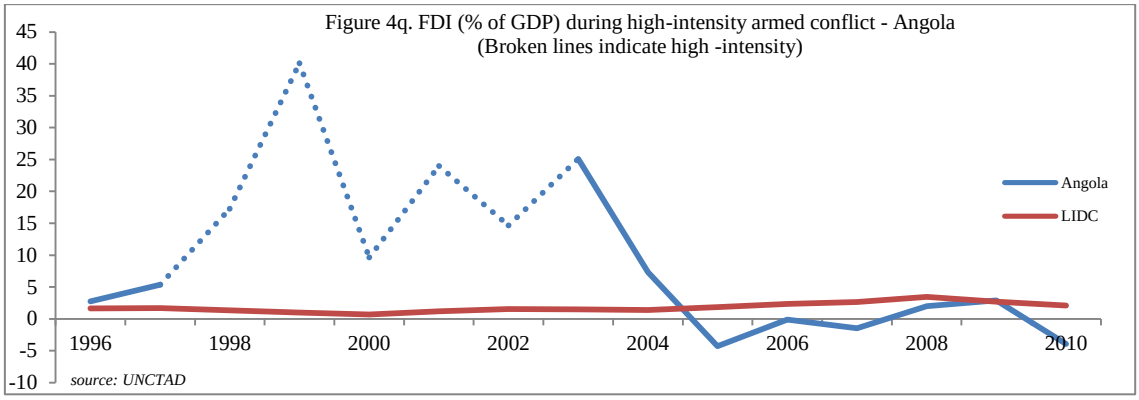
increased. For instance, figure 4o illustrates FDI flows in the Democratic Republic of Congo to be higher during periods of relatively low conflict intensity.



The second trend suggested a counter intuitive relationship where higher rates of FDI would be common during periods of high-intensity armed conflicts. This was supported by FDI data in Angola (1998-2002), Iraq (2004-2010), Sudan (1996-2004 & 2006) and to some extent Rwanda (1998, 2001 & 2009). In the case of Angola, Iraq and Sudan, FDI was noticeably higher during periods of high-intensity armed conflict than any other period with their FDI also outperforming the average for their economic group. Iraq's FDI was particularly interesting as prior to the start of its armed conflict; its FDI hovered just over 0% of its GDP, with FDI increasing exponentially in 2003 when its armed conflict began. Although its armed conflict was at the highest level of conflict intensity and therefore FDI flows could not be compared with low levels of conflict intensity, it's FDI during this period did outperform the average for the LIDC group.

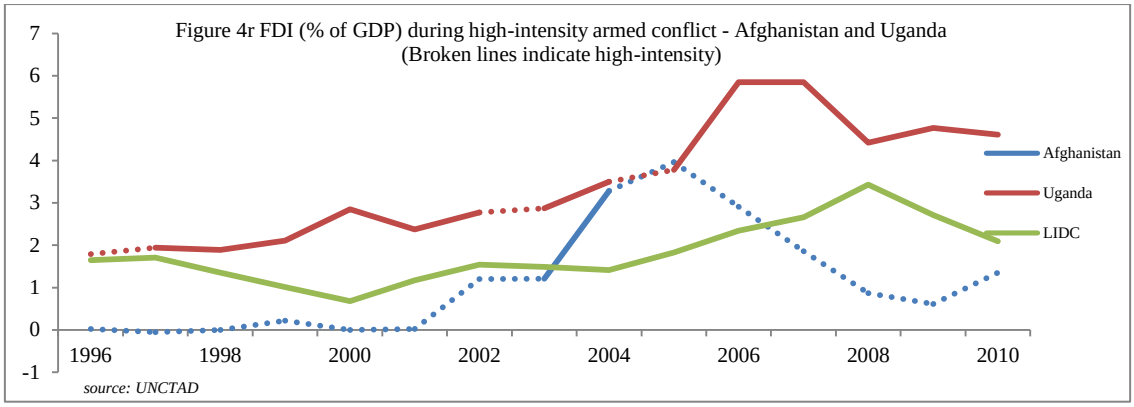


Angola and Sudan also followed a similar pattern to Iraq as their FDI followed an upward trajectory and outperformed the LIDC average during periods of high-intensity armed conflict. FDI data in these cases showed FDI flows in comparison to armed conflict to be higher during periods of high-intensity, with FDI flows falling once armed violence subsided. This further strengthened the argument that there was a positive relationship between high-intensity armed conflict and increased rates of FDI.[67]



And the final trend added to the complexity of the armed conflict-FDI relationship as established in the previous section. In this trend, changes in conflict intensity had no effect on foreign investment with conflict intensity unable to explain why FDI increased. This included data from Afghanistan and Uganda showing FDI flows to be increasing during armed conflict with any changes in the direction of FDI non-attributable to changes in conflict intensity. This was better illustrated in FDI flows for Uganda where periods of high-intensity and low-intensity armed conflict did not affect the upward trajectory of its FDI.

[67] Although Angola's internal armed conflict ended in 2003, it did suffer from armed violence in 2004, 2007 and 2009 according to the PRIO/UDCP Armed Conflict dataset.



The three sets of trends which had been identified in the LIDC group and the evidence which emerged in the more developed countries group suggested that conflict intensity could not explain why foreign investments were still observed in armed conflicts despite Berman's (2000) assertions that high-intensity armed conflict discourages FDI. The data provided sufficient evidence to argue that in most cases high-intensity armed conflict increased foreign investment, and as economic development could not explain why foreign investors continued to choose armed conflicts; this necessitated the need to look for a variable which could explain why this counter intuitive trend continued to be observed.

4.4 External military intervention (EMI) and FDI

A possible variable which could help explain the distribution of FDI into armed conflicts is the independent variable of external military intervention (EMI). This variable has been brought into the investigation as this thesis premises foreign investors' tolerance of conflict affected risks on the presence of foreign troops and argues that EMI in armed conflicts gives out 'positive signalling' which encourages foreign investment. Its presence therefore improves the investment climate by bringing authority and stability to an incendiary economic and political environment. The EMI also works towards repairing investors' confidence by restoring the rule of law,

assisting in the reconstruction of economic and political institutions, reducing the level of violence and working towards a lasting end to the armed conflict. As the previous investigation put forward empirical evidence to show that not all foreign investors were discouraged by armed conflict and that conflict intensity could not explain why foreign investors were attracted to conflict zones, the introduction of the EMI as an independent variable could offer a possible explanation on why foreign investors select armed conflicts as investment destinations.

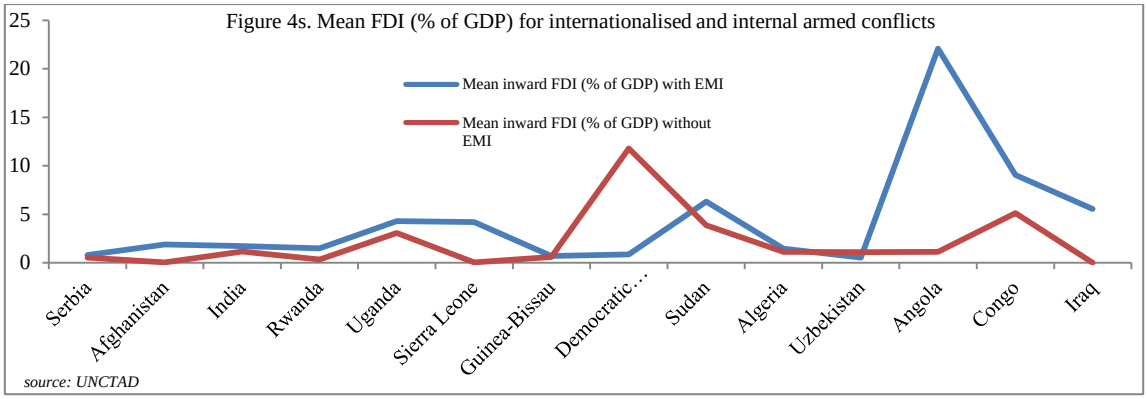
Before presenting the analysis on external military intervention (EMI) on FDI, it is worth explaining the definition of the independent variable and how EMI is coded in the dataset. The UCDP/PRIO Armed Conflict dataset (see Gleditsch 2002, and Themner and Wallensteen 2011) dichotomises internal armed conflicts which are solitarily 'internal' – where all actors participating in armed conflict are of the state – and 'internationalised' – where there is an external military intervention by independent states on behalf of either the state or the non-state actor. Where there is an EMI, the internal armed conflict transforms into an internationalised internal armed conflict as independent states intervene with 'boots on the ground'. Therefore, an EMI in this thesis is defined as the *participation of independent states through 'boots on the ground' on behalf of the state or the non-state actor*.

EMI is the central variable investigated in this thesis. However, the determinants of FDI literature which was discussed in chapter 2 argue that a range of economic, political and social variables should be factored in as they can have a positive influence on foreign investors. Therefore, when discussing the influence of EMI on FDI the analysis also concentrates on additional variables. These include: economic growth; polity type and government effectiveness/corruption; human development/life expectancy; resource endowment; and geographic location. The inclusion of these variables ensures that the

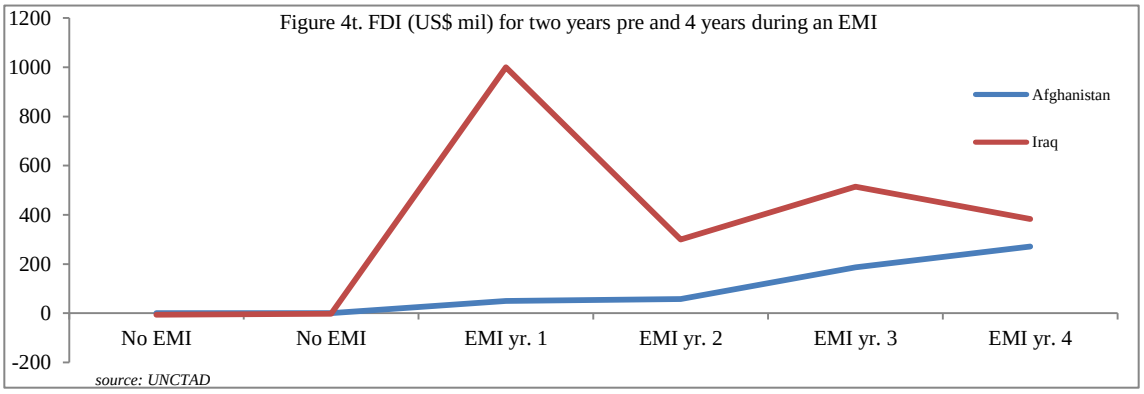
investigation offers a level of scrutiny to the hypothesised relationship between EMI and FDI.

From the large-*N* sample, 14 cases appeared to have been internationalised through an EMI: these included Afghanistan, Algeria, Angola, Congo, Democratic Republic of Congo, Guinea-Bissau, India, Iraq, Rwanda, Serbia, Sierra Leone, Sudan, Uganda and Uzbekistan – and with the exclusion of Guinea-Bissau and Uzbekistan, the remainder were categorised as high-intensity. These cases offered 47 conflict years where an EMI was present with 27 years categorised as high-intensity (see appendix 4.13). The sample was organised under economic development and geography which offered a degree of variance and allowed the investigation to test for the significance of location and economic development against an EMI. Organising the sample in this way showed that 10 armed conflicts came from the low-income developing countries group (LIDC); 2 from the middle-income group (MIDC) and 2 from transition economies. In terms of geography the sample was divided with Europe, the Middle East, Asia and Africa represented.

The data from the sample showed that rates of FDI were higher in armed conflicts where foreign states intervened with 'boots on the ground'. From the sample, 12 cases offered data supporting this contention with only the Democratic Republic of Congo and Uzbekistan showing EMI to have no effect. The data also showed that from the 47 years of armed conflict under an EMI, rates of FDI flows were positive with the exception of 1 year, and under the 27 years of high-intensity armed conflict, 26 years registered positive FDI with the only negative FDI coming from the Democratic Republic of Congo in 1997. The data here suggested that positive flows of FDI in high-intensity armed conflict could be attributable to an EMI.



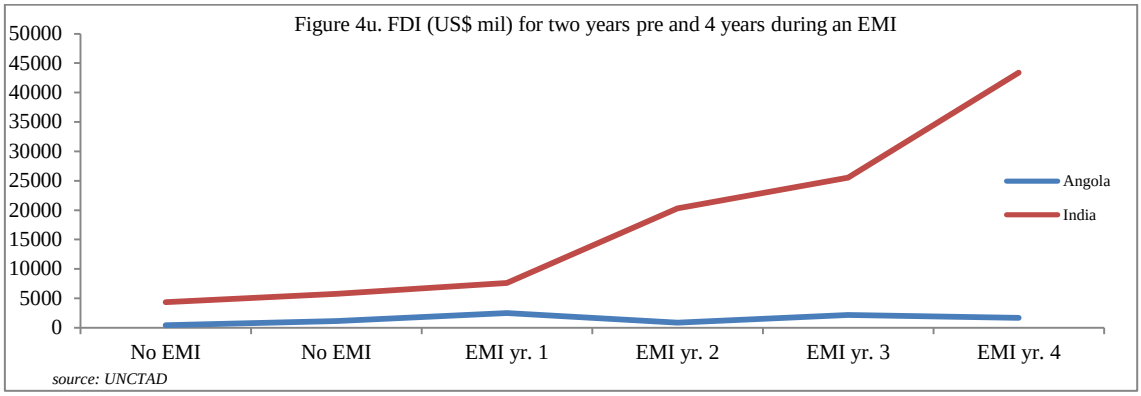
In addition, the data also showed rates of FDI to be higher if an external military was present. From the sample, 12 cases showed higher rates of FDI (mean values) with FDI increasing at least 1 percentage point of GDP when armed conflict had been internationalised through the intervention of foreign troops, however, the Democratic Republic of Congo and Uzbekistan were exceptions to this pattern.[68]



Increases in FDI flows under an EMI were better illustrated by looking at individual cases. Afghanistan, Angola, Congo, Iraq and Sierra Leone were major benefactors of an EMI as their FDI increased exponentially once foreign troops intervened in their armed conflicts. FDI in Angola increased almost 120% of its GDP, whilst Iraq and Sierra Leone saw FDI increase from 0% to 5% of their GDPs. This was also evident in FDI

[68] Serbia, India and Guinea-Bissau also registered increased FDI under an external military intervention, but this was nominal.

data expressed in US$ which saw exponential increases in foreign investments for Afghanistan, Angola, India and Iraq.



The data presented above shows that FDI is likely to be higher under an EMI, compared to countries which experience no external intervention. Within the foreign investment literature, increased FDI flows can be explained by a range of economic, political and social factors which also include economic development and geography. In order to offer a robust scrutiny on the positive influence coming from an EMI, it is important to discuss whether addition factors were also influential in attracting foreign investment.

4.4.1 Location

The first variable was location and as explained above, the sample included cases which represented every region except the Americas. From the sample 9 cases represented Africa; 3 from Asia; 1 from Europe and 1 from the Middle East. When looking at FDI flows under an EMI, the data suggested that location was not an explainable factor as increased FDI flows were not universal to particular regions. The data showed that the at least one case in every region showed increased rates in FDI flows with foreign investment higher under an EMI than without. And although some cases showed that FDI flows didn't improve as in the case of the Democratic Republic of Congo and Uzbekistan, FDI flows still remained positive.

4.4.2 Natural resources

The data for the second variable also indicated that FDI was not dependent on natural resources as increased rates of FDI were observed in cases which had limited natural resources. Natural resources were included in the test because the determinants of FDI literature argues that natural resource endowments promote FDI through resource rent (see Asiedu 2006, and Asiedu and Lien 2010). Resource rent (% of GDP) was used as a measure for natural resources with a mean value calculated for each armed conflict before and during an EMI.[69] The mean values indicated that a cross variation existed in the sample with some cases receiving significant resource rent.[70] The mean values were then cross examined with FDI to assess whether increases in resource rent led to increased FDI (see appendix 4.14).

The data for natural resources indicated that FDI was likely to increase if there were significant resources; however, its affect was limited to a few cases. The data pointed towards two competing trends. The first alluded to a positive relationship between natural resources and FDI flows whilst the second suggested that foreign investment was likely to increase even if natural resources were limited. In the first trend data from 6 cases showed an increase in resource rent leading to increased FDI flows. This included data from Afghanistan, Angola, Guinea-Bissau, Iraq, Serbia and Sierra Leone, with the Democratic Republic of Congo confirming this relationship by showing a reverse relationship where falling rates in resource revenue led to falling rates in FDI.

The second trend countered the positive influence coming from resource rent. In this trend data from Algeria, Congo, India, Rwanda, Sudan and Uganda showed that natural resources had no influence on foreign investment as falling resource rents did not affect

[69] Data for resource rent was taken from the World Bank databank.
[70] The data indicated that significant variations existed in resource rent with low 0.64 to high 86.61 (% of GDP) with an EMI and 0 to 75.27 (% of GDP) without an EMI (see appendix 4.14).

FDI flows. This was confirmed by Uzbekistan where a reverse relationship existed where increases in resource rents coincided with falling rates in FDI. The two contrasting trends suggested that natural resources had no significant influence on FDI as the intuitive relationship could not be extrapolated across the sample (see appendix 4.14).

4.4.3 Human development

Human development was also tested as it is considered a key driver of economic growth, with enhanced human development likely to attract foreign investors (see Majeed and Ahmad 2008). To test for human development, data on life expectancy was used.[71] The data followed a similar pattern to natural resources with two competing trends. The first trend showed life expectancy to influence foreign investment with data from Afghanistan, Algeria, Rwanda, Sierra Leone and Uganda showing FDI likely to increase under a higher life expectancy score. This relationship was supported by a reverse relationship where lower levels of life expectancy were associated with falling rates in FDI for the Democratic Republic of Congo.

The second trend suggested that human development was only a factor in a limited number of cases as a competing relationship was also observed. In this relationship human development had no influence on FDI as data from Angola, Congo, Guinea-Bissau, India, Iraq, Serbia and Sudan showed FDI to increase regardless of falling life expectancy. This was supported by data from Uzbekistan where FDI fell without any movement in life expectancy. As an equal number of cases showed two different and distinct relationships, the only conclusion that could be drawn was that human development was influential in attracting FDI but its affect was limited to a few cases (see appendix 4.14).

[71] The data for human development/life expectancy was taken from the World Bank databank.

4.4.4 Growth

Economic growth is considered as having a bi-directional positive effect on foreign investment as strong economic growth strengthens the investment climate and leads to increased flows of foreign investment (see Kyuntae and Hokyung 2008, Kang 2010, Srinivasan, Kalaivani and Ibrahim 2010). Therefore it was essential to test whether the hypothesised relationship between economic growth and FDI could explain increased rates of FDI flows into high-intensity armed conflicts. The data on economic growth followed a similar pattern to what was observed in the other variables as the cases in the sample were split between economic growth having a positive influence and economic growth having no influence on FDI.[72] Data from Afghanistan, Algeria, Guinea-Bissau, India, Iraq and Sierra Leone showed increased FDI to correspond with higher rates of economic growth with data from the Democratic Republic of Congo and Uzbekistan confirming this relationship by showing how reductions in economic growth led to falling rates in FDI. In addition to this, the remaining cases offered support for a more counter intuitive relationship where economic growth had little to no effect on FDI flows as data from Angola, Congo, Rwanda, Serbia, Sudan and Uganda pointed towards increased FDI corresponding with reductions in economic growth. The two conflicting trends therefore suggested that economic growth was only influential to FDI in some of the cases with the hypothesised relationship unable to be extrapolated across the sample (see appendix 4.14).

4.4.5 Political system

And the final test measured two political variables as a factor for increased FDI flows. This included political system (polity) which measures the level of democracy, and government effectiveness (corruption) which measures the environment in which

[72] Data on economic growth was taken from the World Bank databank.

business is conducted. These variables were seen as determinants of FDI as strong democracy leads to increased FDI (see Jensen 2003) and government ineffectiveness is detrimental to the investment climate as it increases the cost of doing business (see Sadig 2009).[73]

The data on political systems indicated that all the cases - with the exception of the Democratic Republic of Congo and India - had weak democracies before an EMI, with slight improvements registered once foreign states intervened with 'boots on the ground'; however, this was nominal as the scores still indicated weak democracies. Nevertheless, the data revealed that FDI was likely to increase if the political system improved and this was supported by FDI flows in Algeria, Angola, Guinea-Bissau, Iraq, Rwanda and Uganda. Although this connection was made, the data could not say with certainty that political system was a factor for improved FDI as the low scores in the political system still indicated weak democracies. This belief was confirmed by the data presented in the remaining cases (Afghanistan, Congo, India, Serbia, Sierra Leone and Sudan) where FDI continued to increase despite the weakening of the political systems (see appendix 4.14).

The second variable which measured the business environment by looking at government effectiveness (corruption) was unable to provide sufficient support to prove that government effectiveness improved FDI as two competing trends emerged. The data on corruption indicated that every case in the sample suffered from a high level of corruption which was synonymous with weak democracies (see Warren 2004). The first trend suggested a possible relationship between government effectiveness and FDI as some cases in the sample including Afghanistan, Algeria, India, Iraq and Rwanda

[73] The data for polity was taken from the Polity IV Project (see Marshall, Jaggers and Gurr 2010) and the data for government effectiveness as measured by level of corruption was taken from the World Bank databank. The data for polity represents the level of democracy with 20 assigned as high democracy and 0 as low democracy. Additionally for level of corruption a value of -2.5 to +2.5 is assigned with the highest value corresponding to greater governance.

showed a positive relationship between government effectiveness and FDI. In these cases FDI flows increased as corruption fell, and data from the Democratic Republic of Congo and Uzbekistan confirmed this relationship by showing a reverse trend between high levels of corruption and falling rates in FDI.[74]

Although this showed that FDI was positively related to government effectiveness, a handful of cases emerged to show a conflicting trend where there was no relationship as FDI flows increased even when there was a high level of corruption. In the cases of Angola, Congo, Sierra Leone, Sudan and Uganda, rates of FDI was higher when scores for government effectiveness were at their lowest which suggested that any intuitive relationship was specific to individual cases (see appendix 4.14).

4.5 FDI and 'following the flag'

Up until now this chapter has emphasised that external military intervention (EMI) can be expected to increase foreign investment, and the discussion on additional variables has provided additional evidence to support this conclusion. The premise of this variable is grounded in the argument that EMI gives out 'positive signalling' which encourages FDI, and although this chapter has been able to prefix FDI to EMI, it has not been able to establish whether foreign investors follow the military intervention in armed conflicts or whether EMI improves the situation on the ground before foreign investors follow.

The intervention of foreign troops can have an adverse effect on an on-going armed conflict as it could impact on conflict dynamics in a number of ways. Although it is assumed that an intervention can bring an end to hostilities, the immediate reaction to an EMI can lead to changes in conflict dynamics; in particular on conflict intensity as the

[74] It must be noted that although improvement in government effectiveness were visible, the improved values were still significantly low. For instance out of the 5 cases where improvements in government effectiveness led to a better investment climate, Rwanda had the least amount of corruption (0.31) on a scale of -2.5 - +2.5 with the higher value corresponding to better governance.

presence of foreign troops can either lead to an escalation or reduction in armed violence. Nevertheless, how armed conflict reacts to the presence of foreign troops could also be detrimental to FDI as any escalation in armed conflict would inevitably discourage foreign investors and lead to disinvestment. So far, this chapter has put forward empirical evidence to show that the presence of foreign troops can explain increased FDI in armed conflicts; however, it has not established whether this is the direct result of the EMI or changes in conflict intensity.

The final investigation in this chapter assessed whether the improvement in the investment climate through an EMI was related to reductions in conflict intensity or the end of the armed conflict. This test was necessitated in order to verify whether increased FDI in armed conflicts was a result of the EMI or changes in conflict intensity. Although the majority of the cases did not offer much in analysis, some evidence emerged to show that increased FDI was more dependent on the EMI rather than reductions in conflict intensity. For instance, in Afghanistan, Angola and Iraq, rates of FDI were higher under an EMI despite no changes in conflict intensity. This suggested that FDI was dependent on the EMI rather than changes in conflict intensity and as increased FDI flows were observed over a period of time, which in the case of Afghanistan lasted from 2001 until 2012; Angola from 1998 until 2003 and Iraq from 2003 until 2010, it reinforced the importance of EMI to FDI in armed conflicts (see appendix 4.13).

Armed conflicts in Congo and India also added further evidence to this observation; however, these armed conflicts also showed how EMI had a positive effect as the intervention led to an end of hostilities (although this was not an immediate response to the EMI). In both armed conflicts, the EMI led to a reduction in conflict intensity, although this was in the 3rd year with peace achieved in the following year. Although

peace was not achieved immediately, the reduction in conflict intensity led to better investment levels with peace bringing further investment prosperity to India after the end of its armed conflict. It was expected that the same would apply to Congo, which also registered increased FDI when its conflict intensity fell, however, the return to peace and the withdrawal of foreign troops led to reductions in FDI which were below FDI levels during armed conflict.[75] This suggested that although the reduction in conflict intensity improved its ability to attract FDI, the removal of foreign troops had an adverse effect as it led to reductions in FDI (see appendix 4.13).

4.6 Conclusion

This chapter has put forward empirical evidence to show that foreign investors sometimes continue to select conflict zones as investment destinations, despite the increased level of commercial and non-commercial risks. In doing so, this chapter has also put forward empirical evidence to show that conflict intensity does not affect FDI, whilst countries which experience an EMI tend to report improved or sometimes higher rates of FDI.

The data presented in this chapter offered sufficient evidence in support of hypothesis 1. The data showed that armed conflict did not discourage all foreign investors as sufficient evidence emerged to indicate that FDI continued to flow in armed conflicts with some cases showing FDI increasing after the start of an armed conflict. Dichotomising the sample through economic development also showed that the negative effects of armed conflict, to some extent, were more obvious in developing countries (middle and low-income developing countries) with armed conflicts in developed countries (developed economies – Asia, transition economies and high-

[75] The Democratic Republic of Congo followed similar behaviour to that of India although it FDI ($US mil) was substantially less than India.

income developing countries), showing little negative effects on FDI. Although the negative effects of armed conflict were greater in developing countries, the data indicated that this effect was short term as FDI returned to normal, or in most cases increased above pre-conflict FDI.

The data also showed how the direction of FDI flows was determined by shocks to the investment climate. The data suggested that the direction of foreign investment in the long-term was affected by how foreign investors reacted to conflict onset with immediate reductions in FDI flows leading to a sustained reduction in long term FDI; whilst no changes in the first year of armed conflict leading to no significant changes in FDI flows in the long-term. This suggested that the elasticity of initial investors' expectations regarding armed conflict became inelastic over time as risk premiums for foreign investors increased.

The data presented in this chapter also supported hypothesis 2 as FDI was observed even in armed conflicts which were fought with high-intensity. FDI trends in high-intensity armed conflicts showed that conflict intensity could not explain why foreign investors were attracted to high-intensity armed conflicts as the cost and risk of doing business here was higher. The data indicated that in some cases rates of FDI were higher in high-intensity armed conflicts as witnessed in Afghanistan, Angola, Iraq, Sudan and Uganda. This was in contrast to Berman's (2000) assertion that FDI is dependent on conflict intensity.

There was also sufficient evidence to show that there was a relationship between the independent variable of external military intervention (EMI) and FDI. Here, the data indicated that rates of FDI were higher in armed conflicts where an external military intervened with examples from Afghanistan and Iraq supporting this relationship. The

discussion on additional variables supported the empirical evidence as EMI was the only variable which was consistent throughout the sample.

Finally, there was evidence to support the argument that foreign investors followed the EMI in armed conflicts despite the high level of conflict intensity, although most of the cases in the sample did not offer much data. Where data was available, it suggested that only in some cases did the presence of foreign troops lead to reductions in conflict intensity; however, there was more evidence which pointed to foreign investors following the EMI rather than waiting for conflict intensity to decrease, or for peace to emerge.

The analysis in this chapter looked at FDI in general as it is important to begin the investigation by establishing whether countries involved in armed conflicts can continue to attract FDI. Although the data showed that FDI remained positive, and in most cases increased during armed conflict which suggests that armed conflict led to market opportunities for foreign investors, certain caveats needed to be applied on the method used to analyse the data and the data itself. This included the use of descriptive statistics in analysing FDI trends, whilst the use of aggregate conflict and FDI data questioned whether a more micro-focused analysis was needed in order to understand the armed conflict-FDI relationship. For instance, this chapter used aggregate FDI data which did not permit the investigation to explore whether investment strategies or market sectors could offer a more thorough explanation on why foreign investors continue to choose conflict zones as investment destinations. In addition, this chapter also used aggregate conflict data which presented some aggregation problems as the data classed all the cases as identical armed conflicts even though armed conflict are homogenous and differ in their cause, size, scope and spatiality. This evidently affects foreign investors differently and closer scrutiny of the data would show that the armed conflicts in Russia,

Israel, Turkey and Angola had different dynamics which interacted with foreign investors differently. For instance, Israel's armed conflict was located in the occupied territories and therefore did not affect foreign investors in proper Israel; Russia's armed conflict was in Chechnya which is practically a separate enclave of Russia and had no bearing on investment decisions in Moscow; although Turkey's armed conflict was located within its borders it was confined to its southern border region and therefore did not affect its more commercial and investment intensive areas; and Angola's armed conflict was located within its border with armed violence spilling over into its many urban and commercialised areas. Therefore, it was unfair to compare FDI in all the cases together as the dynamics of each conflict interacted with FDI differently. And finally, the method applied in using aggregated data suggested a correlation between the independent and dependent variable without pointing towards causation. The data was robustly scrutinised as much as the methodology allowed and correlation was achieved through using several datasets, however, this approach did not attempt to explain causation as its positivist leaning limited the thesis to only identifying correlation.

By reflecting on the use of the data and method applied, the findings in this chapter have opened up further areas of research. This includes taking a more in-depth approach to the data by looking at FDI and armed conflict in more specific terms, in particular on identifying how conflict dynamics affect foreign investments and whether investment decisions are based on foreign investors attitudes towards market sectors, size and location of the investment. This approach is considered in the next chapter which uses a structured focused comparison of the case studies of Afghanistan and Iraq, and through disaggregating FDI and armed conflict data attempts to better understand the armed conflict-FDI relationship. It does this through focusing on the spatial dynamics of armed conflict and how this affects foreign investors placement of their investments, and

utilises FDI data by looking at sector specific FDI including specific market opportunities. In order to triangulate the data, chapter 5 also uses a survey of multinational corporations' attitudes towards armed conflict and ties the results with the patterns observed in chapter 4 and 5.

CHAPTER 5: AFGHANISTAN AND IRAQ AS DESTINATIONS FOR FDI

5.1 Introduction: Foreign direct investment and armed conflict in Afghanistan and Iraq (2003-2012)

Do the spatial dynamics of internal armed conflict help explain the distribution of FDI in conflict zones? Does the composition of FDI shed any light as to why foreign investment continues to flow into such places? And do foreign investors 'follow the flag' when selecting investment destinations? These are the questions which have arisen from chapter 4 which put forward, not only, empirical evidence in support of the hypothesis that armed conflict did not discourage foreign investment, but also offered empirical evidence showing that high-intensity armed conflicts did not lead to decreased FDI. In attempting to find an explanation for this counter intuitive trend, chapter 4 applied the independent variable of external military intervention (EMI) to the armed conflict-FDI relationship and argued that the internationalisation of armed conflicts through an EMI led to increased foreign investment which was often above pre-conflict and pre-EMI levels.

The conclusions drawn from chapter 4 were based on analysing aggregate data on armed conflict and FDI which led to certain insights appearing which require a different focus. The first insight stemmed from the use of aggregate armed conflict data and the assumption that all armed conflicts share similar conflict dynamics. Chapter 4 reasoned that within the sample, positive FDI was noticeable in almost all the cases, and although the analysis focused on how conflict intensity affected FDI, it did not investigate how the spatial dynamics of armed conflict affected FDI. The spatial dynamics concept refers to the spread of armed violence within an armed conflict, as some armed conflicts are often 'isolated' – where armed violence is concentrated to remote parts of the

country – or ‘widespread’ – where there is a greater spill-over of armed violence into commercial and urban areas. Therefore, how armed violence spreads will correspond with how foreign investors behave, as intuitively widespread armed conflict will have a greater negative effect on FDI than isolated armed conflicts.

The second insight emerged from the use of aggregate FDI data and the conclusion that armed conflict did not discourage all foreign investors. The analysis indicated positive FDI during armed conflict, however, some cases emerged to show that the start of an armed conflict actually led to increased FDI. The analysis implied that the start of hostilities created market opportunities for foreign investors; however, it later emerged that the investment market during armed conflict is often dynamic and not static which required additional focus.

And the final insight emerged from the application of the independent variable of external military intervention (EMI) and the conclusion that an EMI created market opportunities which led to increased FDI. Although the analysis indicated a correlation between EMI and FDI, the analysis highlighted the need to go beyond this singular focus by investigating whether the proportion of the investment could be tied to the EMI through the ‘following the flag’ (see Biglaiser and Derouen 2007, p. 836) or explained by ‘near home bias’ (see Levis et al. 2010, p. 3). These factors offer contending views on the origin of FDI as the ‘following the flag’ factor connects the investment to countries which contribute ‘boots on the ground’ to the EMI, whilst the ‘near home bias’ factor connects the investments to neighbouring and regional countries.

The three insights which emerged from the analysis in chapter 4 have led to further areas of research which could help expand the armed conflict-FDI relationship. From

these insights, the following 3 areas have been identified which will be addressed in this chapter:

(i) The spatial dynamics of armed conflict in terms of its geographic reach and location;

(ii) The composition of FDI in terms of the sectors which attract foreign investment and

(iii) The proportion of investment tied to occupying forces in order to determine whether 'following the flag' (see Biglaiser and Derouen 2007, p. 836) or 'near home bias' (see Levis et al. 2010, p. 3) factors are present in armed conflicts.

5.1.1 Overview of the chapter

This chapter uses a structured focused comparison of Afghanistan and Iraq and argues that: (i) widespread armed conflict does not discourage FDI as foreign investors locate their investments in areas where armed violence is concentrated; (ii) FDI is not sector specific as the natural resource and non-resource sectors attract foreign investment; and (iii) although FDI is tied to occupying forces through 'following the flag', investors also take advantage of the 'near home bias'.

This chapter is structured as follows. It begins with a brief theoretical discussion of the three areas of research which have been identified above, with a list of questions which are to be asked of the two case studies. A brief discussion of the case studies is offered including reasons for their selection. Following on, the chapter then introduces two new datasets: *Afghanistan/Iraq Coalition Casualty Count* and *FDI Markets* with a brief explanation on how the data is gathered and how it will be applied. The case studies are then analysed thematically with the results presented through a structured focused comparison. Survey evidence is then brought into the analysis which assesses MNCs

perception of political risk as an investment constraint. This survey aims to triangulate the empirical findings of this thesis and offers nuanced arguments in support of the main findings. The chapter concludes by drawing upon the findings and assessing its contribution to the overall objectives of this thesis with a brief discussion of further areas of research.

5.1.2 Spatial dynamics of armed conflict

The validity of conflict intensity as a variable to explain the distribution of FDI was investigated in the previous chapter which concluded that despite high-intensity armed conflict possessing greater risks to foreign investors, it did not discourage FDI. In making this argument, the analysis in chapter 4 highlighted the need to go beyond this singular focus by investigating how the spatial dynamics of armed conflict affected FDI, including how foreign investors react to armed violence spilling-over into commercial and investment intensive areas. Berman (2000) cites that spatial dynamics is useful in explaining FDI in armed conflicts as foreign investors can tolerate the risks of isolated armed conflicts, whilst widespread armed conflict leads to investment reversals. This is based on the intuitive assumption that armed violence in isolated armed conflicts can be contained to remote parts of the country whilst armed violence in widespread armed conflicts leads to spill-over into commercial and investment intensive areas. This spill-over, therefore, puts the investment in close proximity to armed conflict which increases the likelihood of incurring losses through asset destruction and domestic demand shocks as markets contract through forced displacement.

Additionally, if the spatial dynamics of armed conflict is an important determination of FDI, then the location of the investment also serves as an important factor for foreign investors. If foreign investors are reluctant to invest in armed conflicts where armed

violence is widespread, then they will also be reluctant to locate their investments in areas where armed violence is concentrated as this will put the investment in close proximity to armed conflict and therefore increase the likelihood of investment losses.

The spatial dynamics of armed conflict and the location of FDI is the first investigation in this chapter. This investigation carries out a micro analysis of Afghanistan and Iraq's armed conflict by mapping incidents of armed violence to determine their spatial dynamics. The mapping of armed violence is then conjugated with disaggregated FDI in order to identify the location of each investment and whether foreign investments are located in areas where armed conflict is concentrated. By using a micro analysis of armed conflict and disaggregating FDI, this thesis is able to challenge Berman's (2000) assertion that widespread armed conflict discourages FDI. Based on this research design, the investigation asks the following two questions:

1. What are the spatial dynamics of Afghanistan and Iraq's armed conflicts?
2. Are investments located in areas where armed violence is concentrated?

5.1.3 Distribution of FDI

The distribution of FDI in armed conflict is a large part of the armed conflict-FDI puzzle. In chapter 4, the analysis showed that rates of FDI were higher during armed conflict which indicated that the loss of political stability does not deter cross-border investments. Although this was a correct interpretation of the data, the analysis only concentrated on aggregate FDI, rather than focusing on specific market sectors or the heterogeneous nature of the investment such as its size.

The investment market during armed conflict is dynamic as armed conflict generates specific market opportunities in specific sectors which are not necessarily the same during and after an armed conflict. Although decisions on foreign investment during

armed conflict are influenced by factors such as investment payback (Aml, et al. 2011) and high-risk/high-reward (see Demirhan and Masca 2008), the distribution of FDI during armed conflict also suggests that decisions are based on the capital requirements of particular sectors.

Sectors which require intense capital are often seen as being risky investments during armed conflict as they have large operations which require intense resources. These sectors include construction, engineering, extractable resources, services and telecommunications, and although these sectors are highly lucrative, the high level of investment required increases their vulnerability towards asset destruction, with asset theft through corruption and domestic demands shocks increasing their losses. Sectors which require less capital are often more frequent in armed conflicts as they tend to have smaller operations and require less resources which makes them less noticeable, and although these sectors also suffer from asset destruction and losses incurred through asset theft and domestic demand shocks, the risk is reduced as the level of investment is of a relatively smaller value.

Although the natural resource sectors require intense capital, they are seen as an anomaly during armed conflict as they continue to attract FDI. This is partly because it enjoys particular characteristics which act as pull factors for FDI and reduces its vulnerability towards conflict affected risks. The two biggest threats foreign investors face during armed conflict is asset destruction (including theft through corruption) and domestic demand shocks (when markets contract through forced migration) which deter potential investors and act as a catalyst for disinvestment (see chapter 2). Although, every sector is vulnerable to these threats, the unique characteristic of the natural resource sector helps to alleviate the impact from these threats as: (i) losses through domestic demand shocks are mitigated as foreign investors shift towards greater exports

as the product is naturally orientated towards the international market; and (ii) vulnerability towards asset destruction and asset theft are reduced as natural resources are located in frontier regions where security can be increased through either private contractors or host governments securitising resource rich areas. Additionally, as resource revenue also finances military expenditures (see Human Rights Watch 2003), host governments have an incentive to protect operational bases and prevent any disruption to the extraction and exportation of natural resources (see Renner 2002, Le Billon 2004 and Holder and Jacobsen 2007)[76] and (iii) the commodity value and scarcity of natural resources which offers no substitute locations increases the competition to secure unexploited natural resources as foreign investors attempt to benefit from first mover advantage (see Patey 2006). Therefore, securing natural resources during armed conflict is of strategic importance to foreign investors operating in this sector.[77]

The size and distribution of FDI is the second investigation in this chapter. This investigation disaggregates FDI in Afghanistan and Iraq and establishes whether the size of the investment or the sector which attracts investment is relevant in explaining FDI in armed conflicts. Based on this research design, the investigation will ask the following two questions:

3. Is the size of the investment a determinant of FDI in Afghanistan and Iraq?
4. Is the distribution of FDI sector specific in Afghanistan and Iraq?

5.1.4 'Following the flag' or 'near home bias'?

External military intervention (EMI) is a core explanatory variable to the research question - *Why do countries involved in internal armed conflict continue to attract FDI?*

[76]Although the investment can be secured, the investment is not completely risk free as it is reliant on transport networks to take the product from the extraction point to the market. This is often done through oil and gas pipelines which are vulnerable to frequent attacks especially if they run through remote areas which are outside of government control. Therefore, although foreign investors can reduce their exposure to conflict affected risks, they incur losses if they are unable to get the product to the market.

[77] The non-resource sectors are also highly lucrative but as they offer location substitutability - where foreign investors can enter the same sector in more stable countries – their appeal diminishes during armed conflict.

Chapter 4 ascertained that the internationalisation of armed conflict through an EMI led to positive FDI with some cases showing foreign investment to be higher (% of GDP & in US$) under an EMI than without. Although the analysis in the previous chapter showed that rates of FDI were higher when foreign states intervened with 'boots on the ground', it led to an interesting insight which suggested that the proportion of investment could be tied to either occupying forces through the 'following the flag' factor (see Biglaiser and Derouen 2007, p. 836) or tied to the geographic connection between the investors and the investment destination through the 'near home bias' factor (see Levis et al. 2010, p. 3) where investors from neighbouring or regional countries take advantage of market opportunities in armed conflicts.

The two factors offer opposing perspectives on the geographic origin of foreign investments in armed conflicts. The 'following the flag' factor (see Biglaiser and Derouen 2007) emerges from the EMI literature which postulates that military interventions are often motivated by economic interests (see Rosenau 1969) which in the context of EMI implies that countries which intervene in armed conflicts often dominate the investment climate (see Pearson 1974, Carment and Rowlands 1996 and Carpino 2006). The opposing view is provided by the finance literature which puts forward the 'near home bias' factor (see Levis et al. 2010) as dominating the investment climate. This is based on the principle that the close proximity between the investor and the investment destination offers logistical and transaction advantages over investors further afield, whilst foreign investors share a preference for investing in countries where there is an element of cultural, institutional and social familiarity (see French and Poterba 1991 and Huberman 2001). In the context of armed conflict, this factor could be moulded to argue that that the investment climate is dominated by investors who take

advantage of the ‘near home bias’ as cultural, institutional and social familiarity can lessen the risks from armed conflict.

The ‘following the flag’ and the ‘near home bias’ is the third investigation in this chapter. This investigation disaggregates FDI and EMI in Afghanistan and Iraq and attempts to establish whether the proportion of the investment can be tied to: (i) the military intervention; and (ii) neighbouring and regional countries. Based on this research design the investigation will ask the following two questions:

5. Do foreign investors ‘follow the flag’?
6. Is the ‘near home bias’ influential in attracting FDI into Afghanistan and Iraq?

The final part of the investigation is an assessment of political risks. Using survey evidence, risk assessments of MNCs which operate in fragile and conflict affected countries is used to triangulate the findings in the empirical chapters. This survey offer nuanced arguments and reflects the reality of investors’ perception towards armed conflict as a constraint to cross-border investments.

5.2 Case studies

Afghanistan and Iraq have been chosen as the two cases studies for the structured focused comparison. Their selection is based on the performance of their FDI during their respective armed conflicts and under an external military intervention. In addition these cases have been chosen as they offer a degree of similarity and variance.

Afghanistan’s history is blighted with armed conflict from the Soviet invasion of 1979 – 1989; the succeeding Afghan civil conflict of 1989 – 2001 and the subsequent internationalisation of its armed conflict when US and ISAF/NATO (International Security Assistance Force, North Atlantic Treaty Organisation) forces intervened in

2001. Although the intervention was a response to the terrorist attacks of September 11 which led to the ousting of the Taliban from power, it quickly transformed into an internal armed conflict when the Taliban led an armed resistance against all occupying forces and the newly formed Islamic Republic of Afghanistan.[78]

Iraq has also been engulfed in armed conflict over the same period, from its interstate conflict with Iran in 1980 – 1988; the Gulf War of 1990 – 1991; its continuation in 2003 (second Gulf War) when the US and the 'coalition of the willing' (see Schifferes 2003) invaded and the subsequent internal armed conflict when an insurgency emerged straight after. The latter was a consequence of the international conflict in 2003 which led to the overthrow of Saddam Hussein's Ba'athist regime.[79] Although a new government was formed after the 'end of hostilities' were announced in May 2003, (see BBC news, May 2, 2003), an insurgency emerged which opposed all occupying forces and the new newly formed government of Iraq. The situation further deteriorated when intercommunal violence between the Sunni and Shi'a factions flared up in 2007 (see BBC news, February 2, 2007).

Although both countries have a long history of armed conflict, the investigation focuses only on the latter parts of their armed conflicts, which for Afghanistan concerns the internationalisation of its civil conflict from 2003 until 2012, and for Iraq concerns its internal armed conflict which began in 2003 and ended in 2010. The selection of Afghanistan and Iraq therefore provides this chapter with the two most appropriate case studies for a structured focused comparison as: (i) they run parallel with one another which allows a thematic analysis to be carried out which removes longitudinal changes and allows observations to be made over the same time period; (ii) both cases involved

[78]The official name given to Afghanistan's intervention is Operation Enduring Freedom.
[79]The armed conflict in Iraq is also known as the War in Iraq, the Occupation of Iraq, the Second Gulf War (Gulf War II) and more officially Operation Iraqi Freedom.

an external military intervention which was against the government and led to regime change; with (iii) regime change leading to an armed insurgency.

5.3 Datasets

Two new datasets are used which are unique to the study of armed conflict and FDI. These datasets offer disaggregate armed conflict and FDI data which enables this thesis to investigate the spatial dynamics of armed conflict on foreign investment and explore specific trends in FDI. Armed conflict data is taken from the *Afghanistan/Iraq Coalition Casualty Count* which offers data on the spatial dynamics of armed conflict through mapping all violent attacks against occupying forces. This dataset uses public disclosures and official press releases from participating national governments in tracking and mapping the geographic location of all battle related fatalities incurred by occupying forces.[80]

In modern armed conflicts, civilian fatalities represent the greater proportion of all battle related deaths; however, the lack of complete and reliable data on civilian deaths has necessitated the use of coalition fatalities. Although data on civilian deaths does exist through the *Iraq Body Count* and *Casualty Monitor* for Afghanistan, the completeness and reliability of fatality recording systems in both armed conflicts has been widely questioned, whilst its limitations extends to its failure at not mapping where fatalities occur. More reputable data is available through authoritative datasets which includes the Correlates of War project, however, this dataset concentrates on aggregate data, and whilst the UCDP/PRIO Armed Conflict dataset does provide disaggregate data on incidents of armed violence through its ACCLED dataset (The Armed Conflict Location and Event dataset), its data is specific to the African region with no data on Iraq currently available (as of 2nd October, 2013).

[80] The Afghanistan/Iraq Coalition Casualty Count dataset can be accessed: http://icasualties.org/OEF/Index.aspx

FDI data is taken from *FDI Markets* which tracks all Greenfield foreign investments. This dataset which is provided by the *Financial Times* disaggregates FDI and offers information relating to the location of the investment which includes the destination of their operations, the size in US$ and the market sector where the investment is located. This dataset also provides useful information on the investor including their geographic origin and market value.[81]

5.4 FDI trends – Afghanistan and Iraq (1996 – 2012)

The previous chapter established that Afghanistan and Iraq registered higher levels of FDI during their armed conflicts with rates of FDI higher when foreign troops intervened with 'boots on the ground'. In Afghanistan, FDI increased when the US and allied forces intervened in its civil conflict, whilst in Iraq's armed conflict; foreign investment under an EMI was higher than its pre-conflict FDI.

Figure 5a. FDI (% of GDP) during Afghan civil conflict; 1996-2001, and the internationalisation of its armed conflict; 2001-2012

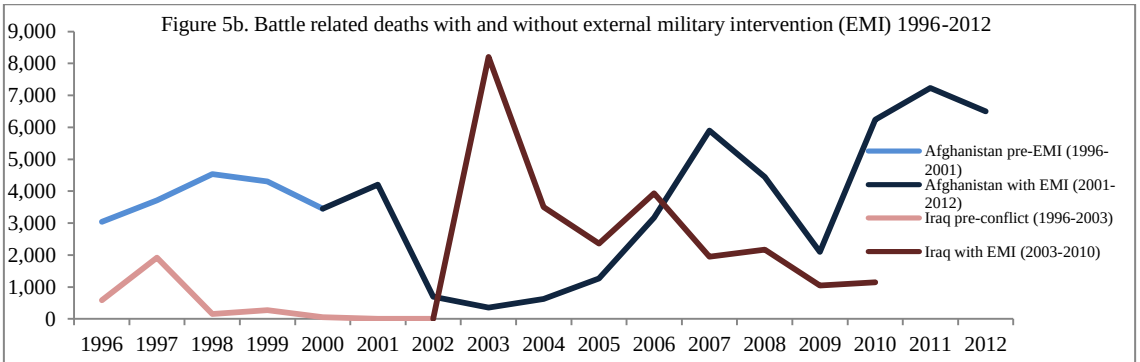
Source: UNCTAD dataset

Before the external military intervention, Afghanistan and Iraq's ability to attract foreign investment was severely crippled through years of economic and political instability, whilst United Nations (UN) sanctions placed embargos on all forms of financial and international trade. In Afghanistan, the two decades of armed conflict from the Soviet invasion of 1979 to the succeeding Afghan civil conflict of 1989 culminated in a non-existent investment climate which was further exacerbated by UN resolution

[81] iCasualties can be accessed at: http://icasualties.org/

1267 which placed an economic embargo prohibiting international investment (see United Nations Security Council Resolution 1267, 15 October, 1999). This led to disinvestment and negative net FDI (see figure 5a). In 2001, when the US and its allies intervened in response to the terrorist attacks of September 11, the resulting regime change led to significant improvements in the investment climate as the new government adopted business-led reforms which were seen to be investment friendly, whilst the UN lifted its economic sanctions in response to the adoption of democracy.[82] Although the adoption of business friendly policies and the lifting of economic sanctions had a positive effect on foreign investors which was reflected in positive FDI trends, the political environment continued to be affected by armed conflict as the change in regime did not bring an end to the Afghan civil conflict.

Figure 5b. Battle related deaths with and without external military intervention (EMI) 1996-2012



source: World Bank dataset/Uppsala Conflct Data Program

Iraq was similar to Afghanistan as it too had a crippling investment climate brought by years of political instability and economic embargos through UN resolutions 661 and 687 which were adopted after Iraq's invasion of Kuwait in 1990, and the suspicion that it was building weapons of mass destruction (WMD). Although Iraq wasn't involved in an armed conflict prior to its EMI in 2003, years of political instability and economic sanctions led to a crippling economy which had a devastating effect on its investment

[82]These reforms included: (i) improving the legal framework for investment; (ii) developing a tax regime and low tax compliance; (iii) reforming its custom administration (iv) developing the transport infrastructure; (v) resolving its complex property laws; (vi) improving the capacity of the state in providing utility services; (vii) improving security; and (viii) strengthening its financial market (see World Bank 2005).

climate which resulted in severe disinvestment which led to negative net FDI (see figure 5c). The invasion by the US and its allies in 2003 transformed the investment climate which started with the removal of the Ba'athist regime and led to the formation of a new government which adopted business-led reforms, whilst the UN adopted Security Council resolution 1483 (see United Nations Security Council Resolution 1483, 22 May, 2003) which called for the lifting of economic sanctions.[83] Although the adoption of investment friendly policies and the lifting of economic sanctions led to foreign investment increasing above pre-conflict FDI, the political environment did not change as armed conflict was reflected in an armed insurgency which began immediately after the EMI in 2003.

Figure 5c. FDI (% of GDP) in Iraq pre-conflict; 1996-2003, and the start of its armed conflict; 2003-2010

Source: UNCTAD dataset

The results from chapter 4 showed that FDI observed in Afghanistan and Iraq was consistent with FDI in the large-*N* sample of armed conflicts which were internationalised through an EMI. In this sample, the evidence pointed towards EMI as positively influencing foreign investment, and although in Afghanistan and Iraq the adoption of business friendly reforms and the lifting of economic sanctions had a positive effect on foreign investors, the continuation of armed conflict under the EMI did not discourage all foreign investment and did not lead to disinvestment. This

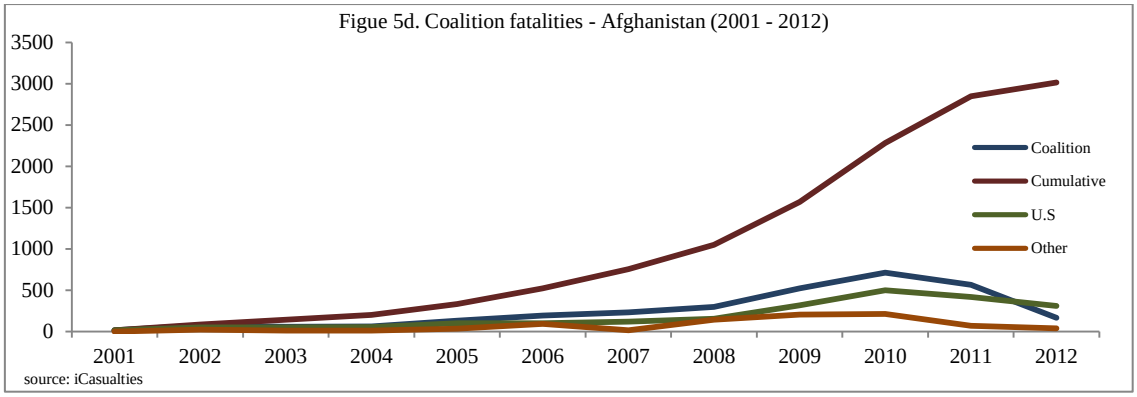
[83] These reforms included: (i) promoting investment and technology transfer; (ii) encouraging foreign investment by providing required facilities for establishing investments; (iii) developing human resources based on market demand; (iv) increase investors rights; and (v) expand exports and improve the balance of payments and the balance of trade of Iraq (see The Investment Law No (13) of 2006)

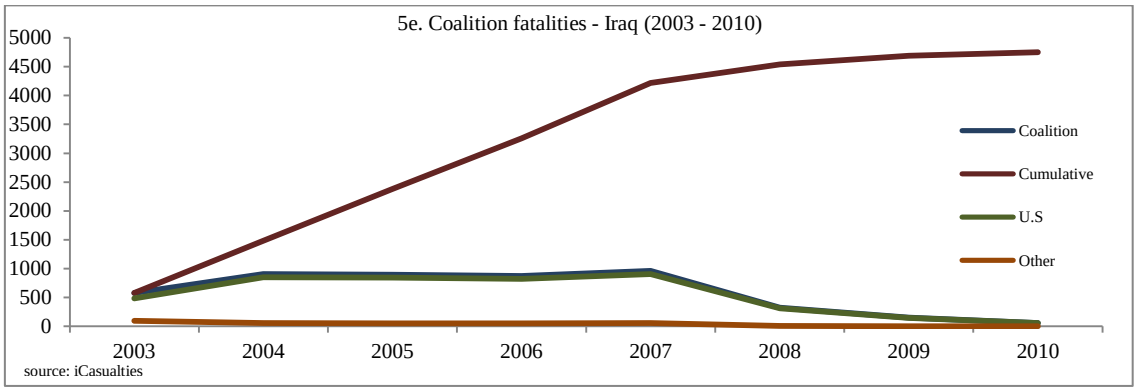
suggested that foreign investors who should have been discouraged by armed conflict were in fact buoyed by the presence of the EMI which mitigated some of the risks associated with armed conflict.

Although increased rates in FDI occurred under an EMI, it was possible that other variables could have influenced foreign investors. Chapter 4 discussed the importance of economic (growth); polity type and government effectiveness/corruption; human development/life expectancy; resource endowments; and geographic location which are key determinants of FDI. In the discussion, chapter 4 concluded that the hypothesised relationships between these variables and FDI was inconsistent and could not be replicated across the sample. This was also consistent with Afghanistan and Iraq as the variables did not have the required hypothesised effect. For example, in Afghanistan, human development, economic growth and government effectiveness had a positive effect on FDI, with democracy and resource endowments having no effect, whilst in Iraq, economic growth, democracy and resource endowment had a positive effect with government effectiveness and human development having no effect. This suggested that the increased rates of foreign investment under an EMI were correctly observed (see appendix 4.15).

5.5 The findings

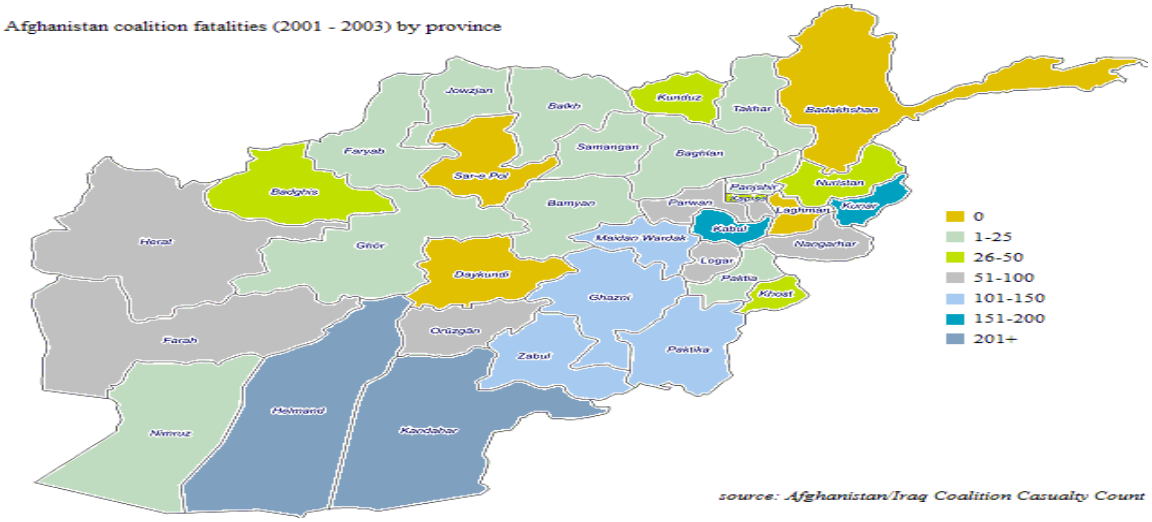
It has already been determined that the armed conflict in Afghanistan (2003 – 2012) and Iraq (2003 – 2010) were fought with high-intensity (see UCDP/PRIO Armed Conflict dataset), and according to the Afghanistan/Iraq Coalition Casualty Count (iCasualties), the spatial dynamics of their armed conflicts were widespread as coalition fatalities occurred in almost every province. Coalition fatalities in Afghanistan were 3,013, whilst in Iraq it was 4,749.





5.5.1 Spatial dynamics of armed conflict – Afghanistan

The 3,013 coalition fatalities in Afghanistan were spread across the country with occupying forces suffering fatalities in almost every province except Badakshan, Sar-e-Pol and Dykundi. The remaining provinces (30) recorded coalition fatalities with the largest number of fatalities occurring in the southern provinces of Helmand (937) and Kandahar (535). The eastern provinces also recorded a large number of coalition fatalities with Kunar reporting 177 coalition fatalities, the capital Kabul with 171 and Paktika with 144.

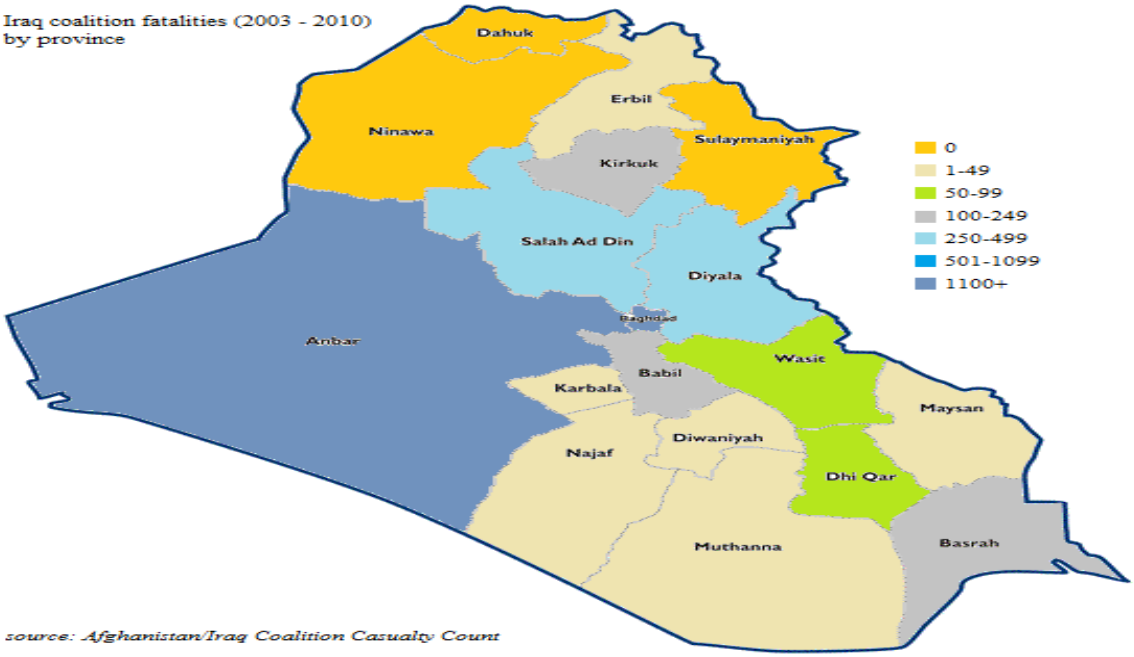


The demographics of coalition fatalities suggest that the majority of Afghanistan's armed conflict was concentrated in the eastern and southern provinces with central, northern and western provinces seeing less armed conflict. The southern province which includes Helmand and Kandahar was the most intensely fought province as coalition fatalities represented 50.9% (1,531) of total fatalities, whilst in the eastern provinces coalition fatalities represented 40.5% (1,220) of total fatalities. The remaining provinces in the centre, north and west were also affected by armed violence, however, as a measure of coalition fatalities, these provinces saw moderate armed conflict as the number of coalition fatalities was less than 9% of total coalition fatalities (central –81 (2.7%); north – 77 (2.6%) and west– 104 (3.3%)) (see appendix 5.1).

5.5.2 Spatial dynamics of armed conflict – Iraq

Iraq recorded 4,749 coalition fatalities which were similarly mapped to Afghanistan. Almost every province was affected by armed violence with the exception of northern Iraqi Kurdistan which included the provinces of Dahuk, Erbil, Nineveh and Sulaymaniyah. Coalition fatalities were observed in the remaining provinces (18) which indicated that the spatial dynamics of Iraq's armed conflict was widespread.

The demographics for coalition fatalities implied that the main concentration of Iraq's armed conflict was in the central and western provinces as coalition fatalities were the highest in these areas. In the central province which included the capital Baghdad, occupying forces suffered 2,502 (52.7%) fatalities with Baghdad alone accounting for 1,479 fatalities. In the western provinces, coalition fatalities were also high as Al Anbar recorded 1,335 fatalities. Although coalition fatalities for these provinces accounted for 80% of total fatalities, the remaining provinces in the east, north and south were also affected by armed violence, although this was relatively modest. The eastern provinces recorded 390 (8.2%) coalition fatalities with 146 (3.1%) fatalities recorded in the north and 376 (7.9%) fatalities recorded in the south (see appendix 5.2).



The data indicates that the spatial dynamics of Afghanistan and Iraq's armed conflicts were geographically widespread with coalition fatalities recorded in almost every province. Although the number of coalition fatalities fluctuated in every province, with some provinces recording fatalities which were uncommon with high-intensity armed conflict, it was clear that armed violence was not contained to remote parts of the

country as spill-over into commercial and urbanised areas were evident. This was supported by the large number of coalition fatalities recorded in the capital of Kabul and Baghdad.

Although the number of coalition fatalities was used in the methodology due to problems of reliability with civilian fatality recording systems, the intensity of both armed conflicts were not disputed as these had already been established through the UCDP/PRIO Armed Conflict dataset, however, when looking at civilian fatalities the data confirmed that both armed conflicts were fought with high-intensity. Although a caveat must be applied before drawing any conclusions, the data from *Causality Monitor* in Afghanistan and *Iraq Body Count* showed that civilian fatalities represented a larger proportion of all battle related deaths as 24,295 civilians were killed in Afghanistan's armed conflict (as of Dec 31, 2011) and 124,640 civilians killed in Iraq (as of May 30, 2013). Therefore, the low levels of coalition fatalities which were recorded in some provinces in Afghanistan and Iraq were not indicative of a low-intensity armed conflict as the estimates on civilian deaths qualified Afghanistan and Iraq as high-intensity armed conflicts.

5.5.3 Location of FDI to armed violence

The previous chapter established Afghanistan and Iraq attracted more investment during their armed conflicts then before. According to Berman (2000) increased flows of cross-border investments during armed conflict can be explained by the spatial dynamics of armed violence as foreign investors continue to locate operations in conflict zones providing that armed violence is concentrated outside of the commercial areas. The previous section put forward empirical evidence to show that the spatial dynamics of both armed conflicts were widespread as coalition fatalities were recorded in almost

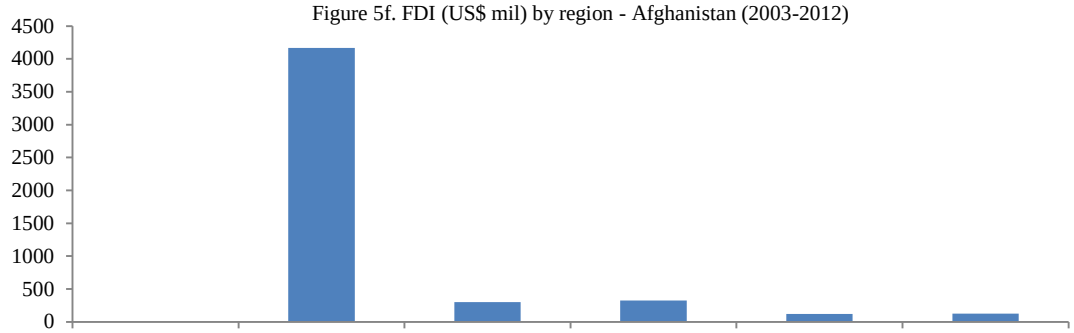
every province, and as FDI increased, the conjugation of the data suggested that foreign investments were being located in areas which had a high concentration of armed violence. This section puts forward empirical evidence to show that despite their spatial dynamics, foreign investors were not discouraged from making investments in areas which were affected by armed violence.

i. Afghanistan

The disaggregate FDI data for Afghanistan shows that foreign investments were located in areas which were affected by armed violence. From 2003 up until 2012, data from *FDI Markets* shows that $5,033 billion worth of investment were made in Afghanistan through 41 investments. From this, $4,733.4 billion (40 investments) was invested in provinces which had a high concentration of armed violence with only $300m (1 investment) located in a province (Sur-e-Pul) that was not affected by armed violence.

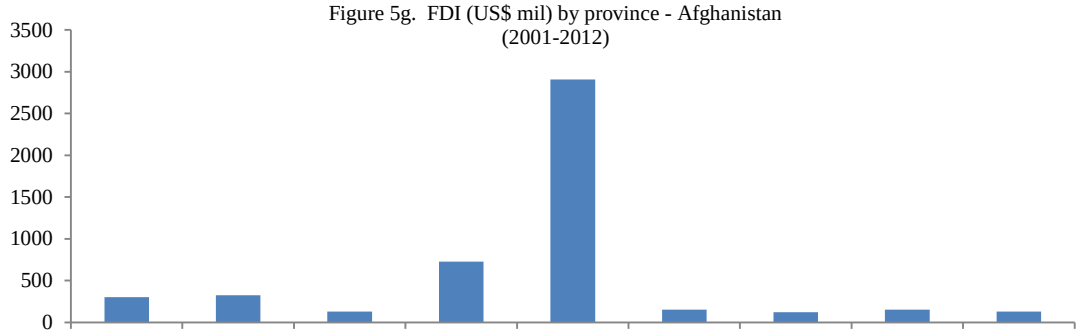
The highest net volume of FDI was invested in the eastern provinces which recorded the second highest coalition fatalities (1,220). These provinces attracted $4,165.7 billion of FDI through 29 investments, with the southern provinces the second largest recipients of FDI with $324.5 million through 3 investments. Although FDI in the southern provinces was relatively modest compared to the eastern provinces, it did see more violence here than in any other province as 1,531 coalition fatalities were recorded. The western province received the least amount of FDI as $118.4 million was invested through 7 investments, and although, outside of the northern provinces, it was the destination of the second least coalition fatalities.

Figure 5f. FDI (US$ mil) by region - Afghanistan (2003-2012)



source: FDI Markets

Figure 5g. FDI (US$ mil) by province - Afghanistan (2001-2012)



source: FDI Markets

The Logar province was the single largest recipient of FDI with $3,134 billion of investment; however, this was not the single largest destination for foreign investors as it only attracted 3 investments. Kabul was the single largest destination for foreign investors as it attracted 21 investments worth $727.1 million even though it also recorded the second largest number of coalition fatalities. In the south, Helmand and Kandahar had the highest concentration of armed violence as it recorded the largest number of coalition fatalities (1531), and although Helmand did not attract FDI, Kandahar managed to attract $354.5 million through 3 investments. It was expected that provinces which were relatively peaceful would attract a high level of investment; however, the data did not indicate this as the Sar-e-Pul province in the north attracted 1

investment of $300 million, whilst the provinces of Baghlan, Balkh, Jowzjan, Kunduz, Samangan and Takhar struggled to attract any FDI.[84]

Table 5a. Coalition fatalities, number and volume of investments (US$ mil) by province – Afghanistan (2001-2012)

Province arranged by region; north (*n*), south (*s*), east (*e*), west (*w*)	Coalition fatalities	Number of investments	Volume of investments (US$ mil)
Sar-e-Pul (n)	0	1	300
Kandahar (s)	535	3	324.5
Ghazni (*e*)	109	2	130.7
Kabul (*e*)	171	21	727.1
Logar (*e*)	64	3	3,134.8
Parwan (*e*)	68	2	171.7
Zabul (*e*)	110	1	1.4
Herat (*w)*	52	7	118.4
Nationwide	n/a	n/a	124.8

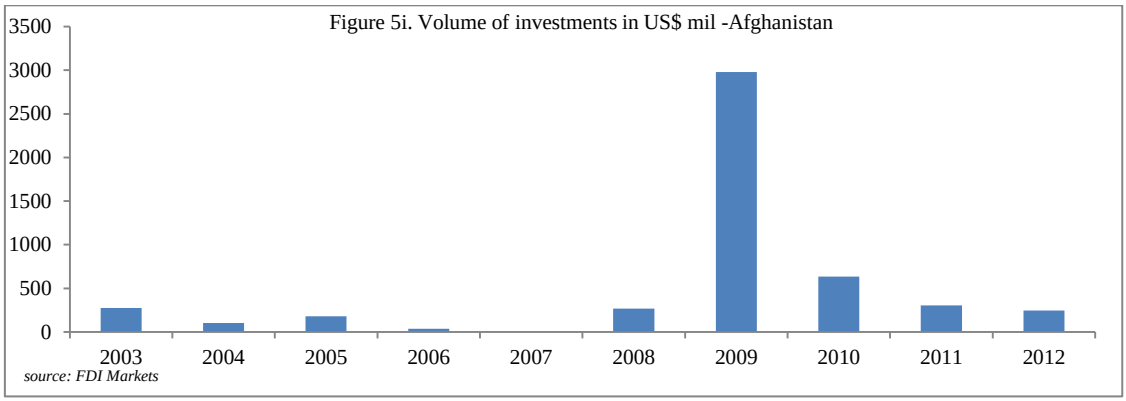
The 41 investments carried out in Afghanistan were spread between 2003 and 2012. In 2003, two years after foreign troops intervened, 6 investments totalling $276.6 million were made despite the presence of armed violence which led to 58 coalition fatalities and 353 battle related deaths.[85]Although the effects of armed conflict and FDI are lagged and therefore, making the argument that coalition fatalities in 2003 did not discourage foreign investors in the same year is slightly inaccurate, it is worth considering that in the previous two years leading up to 2003, armed conflict in Afghanistan led to greater coalition fatalities (82) and battle related deaths (4,908). This level of armed violence should have discouraged foreign investors but as table 5b shows, the presence of armed violence did not lead to foreign investors avoiding Afghanistan as FDI continued to flow.

[84]One investment is listed as being 'nationwide'. This investment was valued at $127.8 million (see appendix 5.3).
[85]Data on battle related deaths was obtained from the World Bank/Uppsala Conflict Data Programme (see http://data.worldbank.org/indicator/VC.BTL.DETH)

Table 5b. Conflict intensity, coalition fatalities, battle related deaths, number and volume of investments (US$ mil) by year – Afghanistan (2003-2012)

Year	Conflict intensity; s*ource: UCDP/PRIO*	Coalition fatalities; s*ource: iCasualties*	Battle related deaths; *source: World Bank*	No. of investments; *source: FDI Markets*	Volume of investments (US$ mil); *source: FDI Markets*
2003	High-intensity	58	353	6	276.6
2004		60	621	4	101.9
2005		131	1,271	5	181.4
2006		191	3,167	3	36
2007		232	5,901	1	5.9
2008		295	4,446	2	269.3
2009		521	2,103	6	2,978.4
2010		711	6,241	9	634.4
2011		566	7,231	3	304.7
2012		166	6,500	2	244.8

If the intuitive argument that armed conflict discourages FDI is to be believed, then the presence of armed violence did have a negative effect in the following years after 2003, although no particular pattern emerged thereafter. After 2003, the number of investments fell which coincided with an upward trajectory in coalition fatalities as battle related deaths reached its peak in 2010. During this period, the number of investments and the level of FDI were sporadic as the data indicated fluctuations in annual FDI and in the number of investments. Although no patterns emerged in FDI which could be correlated with changes in coalition fatalities and battle related deaths, it was clear that the presence of armed violence did not discourage foreign investors. It was also clear from the data that FDI was much higher when coalition fatalities and battle related deaths reached high points as in 2005, 2008, 2009, 2010 and 2011. However, as the effect between armed conflict and FDI is lagged, it was uncertain to say that armed conflict had no effect on FDI in the years when coalition fatalities and battle related deaths increased.



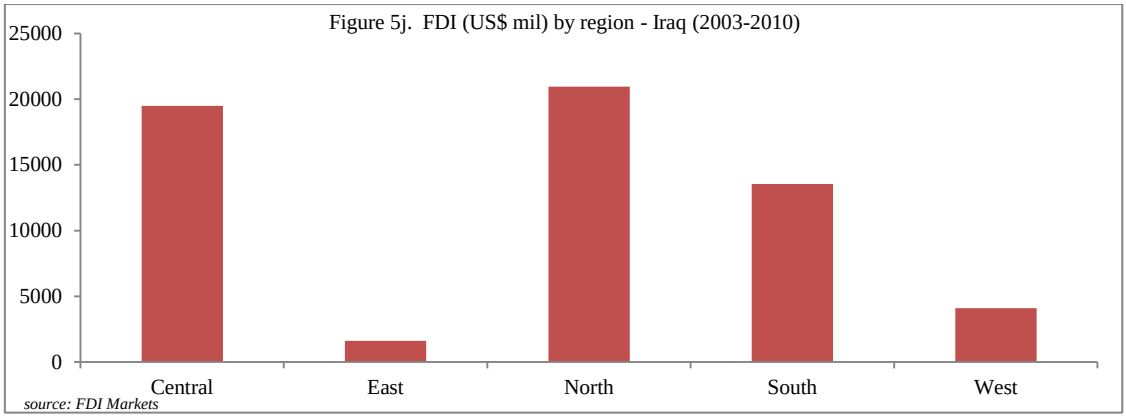
ii. Iraq

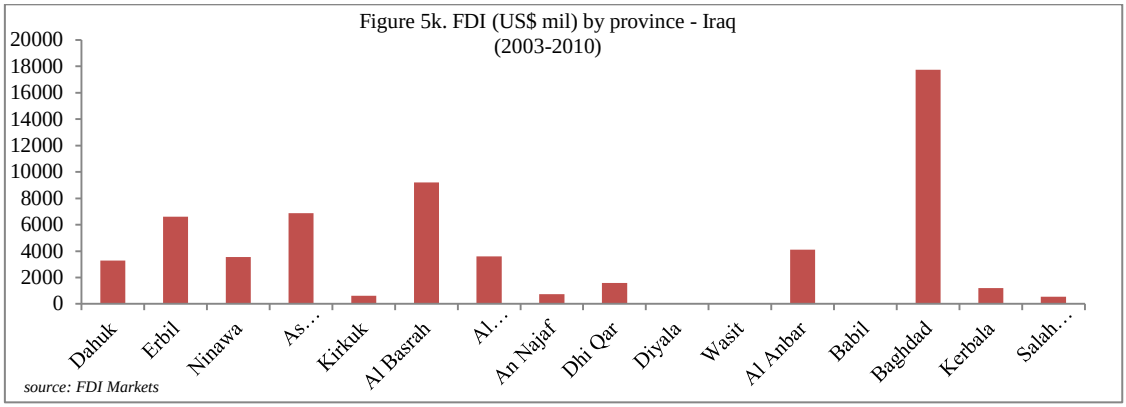
The trends observed in Afghanistan were supported by the data in Iraq. This suggests that the indifferent pattern of FDI in armed conflicts was not particular to Afghanistan but is probably part of a wider trend of FDI in armed conflicts. Iraq was similar to Afghanistan as its armed conflict was also high-intensity with foreign investments located in provinces which were affected by armed violence; however, Iraq attracted considerably more FDI and recorded more coalition fatalities and battle related deaths over a shorter period of time compared to Afghanistan. The data shows that Iraq attracted $59,724 billion of FDI through 159 investments, with $45,997 billion through 143 investments located in provinces which were affected by armed violence. Although the spatial dynamics of its armed conflict was widespread, it did manage to prevent armed violence spilling-over into the northern provinces of As Sulaimaniyah, Dahuk

and Ninawa recorded no coalition fatalities and subsequently attracted $13,727 billion of FDI.

The highest net volume of FDI was located in the northern provinces which received $20,947 billion of investments through 55 investments but also recorded the least amount of coalition fatalities (146). Although the north of the country saw relatively less armed violence and received significant FDI, neighbouring provinces in the centre of the country was a hotbed for armed conflict. These provinces which included Babil, the capital Baghdad, Karbala and Salah Ad Din recorded the largest coalition fatalities (2,502) but still managed to attract significant FDI with $19,492 billion coming from 60 investments.

The southern provinces were the third largest recipients of FDI as it attracted $13,551 billion through 29 investments, however, its level of investment and the intensity of its armed violence were less than the northern and central provinces. This suggested that there was no correlation between coalition fatalities and FDI as provinces which had a higher concentration of armed violence also attracted the greatest number of investments and the largest volume of FDI. Although this was consistent with the central, northern and southern provinces, the western provinces did reflect armed conflicts negative effect on FDI as it emerged as the most violent province (1,335) which resulted in FDI of $4,107 billion. Although this was relatively low compared to the central, northern and southern provinces, it was still significantly higher than the eastern provinces.





Baghdad was the most violent province as it recorded the largest number of coalition fatalities (1,479), however, this did not discourage foreign investors as it emerged as the largest recipient and single largest destination for FDI with $17,754 billion invested through 53 investments. This again supported the earlier argument that the presence of armed violence did not discourage foreign investors, which was supported by FDI in Al Anbar which was the second most violent province yet managed to attract FDI of $4,107 billion.

Although the high level of coalition fatalities did not discourage foreign investors from investing in some of the most violent provinces in Iraq, some of the largest recipients of FDI outside of Baghdad did benefit from low levels of armed violence. For instance, the Al Basra and Erbil provinces were mildly affected by armed violence which led to Al Basra becoming the second largest recipient of FDI with $9,194 billion, whilst Erbil

emerged as the destination for the second largest number of investments (34) with FDI of $6,609 billion. Despite the low levels of armed violence in these provinces and the high volume of FDI, their investment levels were still below some of the worst affected provinces including Al Anbar and Baghdad.

Table 5c. Coalition fatalities, number and volume of investments (US$ mil) by province – Iraq (2003-2010)

Province arranged by region; north (*n*), south (*s*), east (*e*), west (*w*)	Coalition fatalities	Number of investments	Volume of investments (US$ mil)
As Sulaimaniyah (*n*)	0	9	6,884.2
Dahuk (*n*)	0	4	3,295.4
Erbil (*n*)	17	34	6,609.1
Kirkuk (*n*)	129	5	611
Ninawa (*n*)	0	3	3,548.1
Al Basra (*s*)	190	21	9,194.5
Al Muthanna(*s*)	11	3	3,611.8
An Najaf(*s*)	46	5	745.5
DhiQar (*e*)	129	5	1,594.9
Diyala (*e*)	279	1	15.1
Wasit (*e*)	55	1	15.1
Al Anbar (*w*)	1,335	8	4,107.4
Babil (*c*)	258	1	2
Baghdad (*c*)	1,479	53	17,754.1
Kerbala (*c*)	227	3	1,200
Salah Ad Din (*c*)	469	3	536.6

In a similar pattern to Afghanistan, FDI in Iraq was also distributed across the country, however, unlike Afghanistan which indicated no pattern existed between increases in coalition and battle related deaths to FDI, Iraq's FDI was punctuated with increases in coalition fatalities and battle related deaths. Throughout Iraq's armed conflict from 2003 until 2010, $59,724 billion of investments were carried out through 159 investments with the first year alone attracting $6,084 through 32 investments which accounted for over 10% of its total FDI. Although the start of hostilities should have led to foreign investors avoiding it as an investment destination, the high number of coalition fatalities and battle related deaths had an opposite effect as the upsurge in foreign investments in 2003 was greater than any other period over the previous 20 years.

Although it must again be reiterated that the effects of armed conflict and FDI are lagged and under no circumstances should a correlation be drawn between the high

number of coalition fatalities and battle related deaths to FDI, the increase in foreign investment suggested that the presence of armed violence did not discourage foreign investors. This was qualified by FDI trends in its pre-conflict years where Iraq – although under an economic embargo – had lower levels of FDI compared to its conflict years.

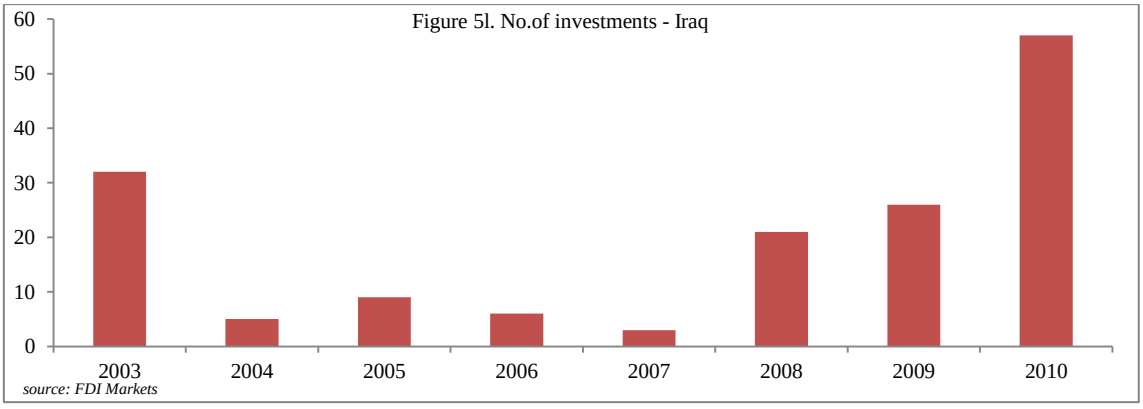
After 2003, Iraq's FDI can be split into two distinct periods. The first from 2004 until 2007 was characterised with annual increases in coalition fatalities and battle related deaths which led to fluctuations in its FDI, and the second period from 2008 until 2010 where its security improved which inevitably led to improvements in its FDI. The first period was its most intense as over 3,637 coalition fatalities and 11,744 battle related deaths were recorded which was in contrast to the second period where coalition fatalities were 532 and battle related deaths stood at 4,362. The data showed that the high fatality rate in the first period had a detrimental effect on FDI as foreign investment in 2004 accounted for only 1% of FDI in the previous year, with total FDI in the first period significantly below FDI in the second period. Between 2004 and 2007, Iraq attracted 23 investments totalling $10,468 billion which represented only 17.5% of its total FDI.

Figure 5d. Conflict intensity, coalition fatalities, battle related deaths, number and volume of investment (US$ mil) by year – Iraq (2003-2010)

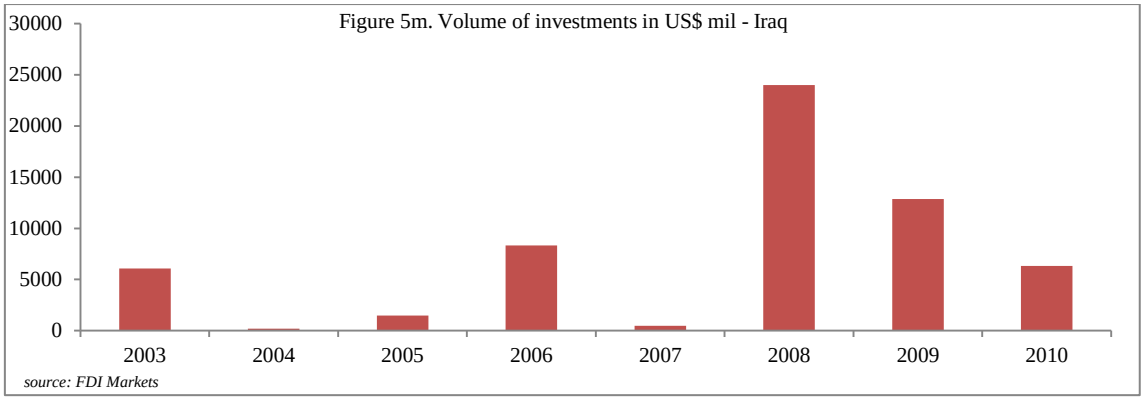
Year	Conflict intensity; *source: UCDP/PRIO*	Coalition fatalities; *source: iCasualties*	Battle related deaths; *source: World Bank*	No. of investments; *source: FDI Markets*	Volume of investments (US$ mil); *source: FDI Markets*
2003	High intensity	592	820	32	6,084.6
2004		906	3,499	5	196.9
2005		897	2,364	9	1,463.6
2006		873	3,933	6	8,333.9
2007		961	1,948	3	474.4
2008		322	2,174	21	2,3981.6
2009		150	1,044	26	12,848.7
2010		60	1,144	57	6,341.2

FDI in the second period was much improved as this coincided with reductions in coalition fatalities and battle related deaths. From 2008 until 2010, Iraq attracted 104 investments totalling $43,171 billion which was a 412% increase from the previous period and represented 82.5% of its total FDI. This period also saw a fall in coalition fatalities and battle related deaths by 69%. Although it seems that armed conflict-FDI relationship in this period was intuitive, the actual relationship was counter intuitive especially when lagged effect was taken into account. For instance, the previous period recorded the largest proportion of coalition fatalities and battle related deaths along with low levels of FDI, however, because of the lagged effect the increase in fatalities and the reduction in FDI could not be correlated. Moreover, the increase in fatalities in the first period could certainly be correlated with FDI in the second period which should have led to further reductions in FDI; but instead, FDI increased which suggested that the high number of fatalities in the first period corresponded with increases in FDI in the second period.

Figure 5l. No.of investments - Iraq



source: FDI Markets



Another interesting pattern also emerged in the second period which showed that the reduction in coalition fatalities and battle related deaths led to annual increase in the number of investments but also led to decreases in total FDI. For instance, Iraq attracted 21 investments in 2008; 26 in 2009; and 57 in 2010, but total FDI in this period dropped every year from $23,981 billion in 2008; $12,848 billion in 2009; and $6,341 billion in 2010. This suggested that as the number of investments increased, the average investment size decreased as foreign investors started to make smaller investments.

5.6 Disaggregate FDI

The pattern observed in the second period during Iraq's armed conflict alluded to the possibility that investment size could be a key factor in explaining FDI. The theoretical perspective offered by Berman (2000) suggests that small investments are frequent in armed conflicts as they carry fewer risks and in the event the investment is destroyed or lost (through theft and expropriation), the losses incurred by the investor are reduced. Therefore it was necessary to investigate whether the size of the investment could explain FDI in armed conflicts.

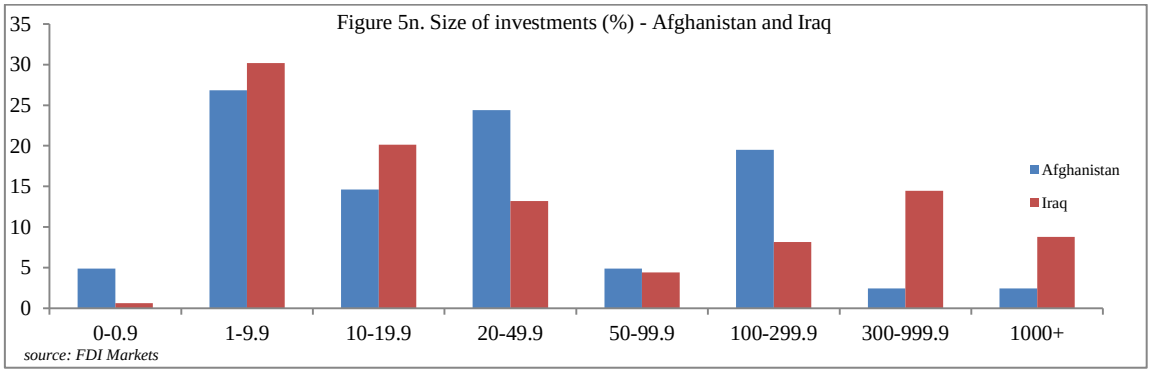
5.6.1 Size of investments

i. Afghanistan

Starting the analysis with Afghanistan, the data shows that the size of each investment varied with small, medium and large investments frequently made. From the 41 investments that were made between 2003 and 2012, almost every investment was above $1 million, with 2 investments falling below this level. These included a $100,000 investment by Home Essentials in 2005 in consumer products and a $400,000 investment by Move One in the transport sector in 2011. The investments which were above $1 million were split into several categories depending on their value. The first category included investments which fell in the $1-9.9 million range which attracted 11 investments and represented 26% of total investments. The second category included investments in the $10-19.9 million range of which attracted 6 investments and represented 14.63% of total investments. These 2 categories were considered small investments which along with the 2 investments which fell below $1 million dollars attracted the largest number of investments which represented just over 45% of total investments.

The next category included investments which were considered to be medium size. These included 10 investments (24.4%) in the $20-49.9 million range and 2 investments in the $50-99.9 million range. Combined, these two categories attracted 12 investments which represented just over 29% of total investments and indicated that there was an intuitive relationship between the size of the investment and its frequency. This was confirmed in the large investment category which attracted the fewest number of investments. The $100-299.9 range attracted 9 investments and although no investments were made in the $300-999.9 million range, 1 investment over $1 billion was made which combined, represented 24.28% of total investments. This confirmed the intuitive expectation that capital intensive investments are infrequent in armed conflicts.

Although a natural and expected trend was observed in the data, a disordered trend also emerged when investments were analysed by value. This suggested that there was no correlation between the size of the investment and its frequency as some of the large value categories were able to attract more investments than the small and medium value categories. For instance, there were more investments above $1 million than below, with the $1-9.9 million range attracting over 80% more investments than the $0-0.9 million range, whilst a greater number of investments were made in the $100-299.9 million range than there were in the $10-19.9 and $50-99.9 million range. This suggested that the size of the investment had no bearing on its frequency (see appendix 5.5).



ii. Iraq

Iraq followed a similar trend to that of Afghanistan as it was also able to attract investments of different sizes. From the 159 investments that were made between 2003 and 2010, only 1 investment fell below $1 million which was a $200,000 investment by VA Tech in the business services sector immediately after the start of its armed conflict. The remainder of the investments were valued above $1 million which were split in similar categories as Afghanistan with small investments representing the greater proportion of investments. Iraq attracted 46 investments in the $1-9.9 million range which represented 30% of total investments with 32 investments in the $10-19.9 million

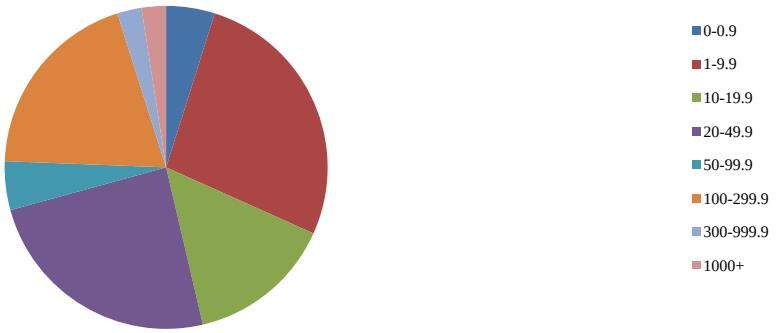
range representing 20% of total investments. Combined, the investments in these categories represented 50% of Iraq's total investments which was consistent with the data in Afghanistan which showed a greater frequency of small investments.

In the medium size category, 21 investments were made in the $20-49.9 million range with 7 investments in the $50-99.9 million range, which combined represented 17.6% of its total investments. In comparison with Afghanistan, Iraq attracted fewer investments in this range as Afghanistan attracted more medium size investments (29%). Although Iraq attracted fewer investments in this category, it attracted more large investments, including more investments which were valued above $1 billion. In the $100-299 million range, 13 investments were made which represented 8.17% of total investments with a further 23 investments in the $300-999.9 million range. In addition, 14 investments over $1 billion were also made, which gave Iraq a higher proportion of investments in the large category compared to Afghanistan as investments in this category represented 31.43 % of its total investments.

In Afghanistan, the initial trend suggested that as the size of the investment increased, its frequency decreased as the number of investments in the small, medium and large categories followed a logical order. This was expected as the number of investors who have, or are willing to invest in capital intense industries decreases as the level of investment increases; however, in Iraq the opposite was observed as the number of investments in the large category was greater than the number of investments in the medium category. Although most of Iraq's investments were made in its small investment category which was consistent with Afghanistan, the logical relationship in Afghanistan was disputed by the trend in Iraq.

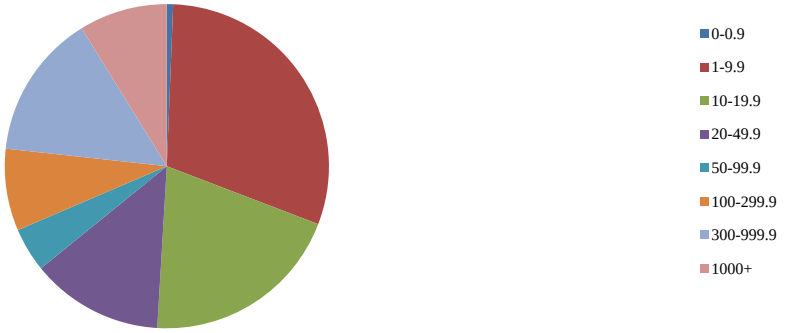
The data on Afghanistan also suggested that no orderly pattern emerged when analysing investments by values as some of the large investment categories attracted more investments than some of the small investment categories. In Iraq, the data supported this observation as there was an unexpected increase in the frequency of investments as the size of the investment increased. For instance, in the first 4 categories starting from $1-9.9 million up to $50-99.9 million, the frequency of investments decreased in every investment category as the size of the investment increased which was consistent with Berman's (2000) assertion that large investments are uncommon in armed conflicts. However, a shift then occurred in the next 2 categories where the size of the investment increased as 13 investments were made in the $100-299.9 million range and 23 investments were made in the $300-999.9 million range. Although the number of investments then dropped in the next category ($1 billon+), the interruption in the trend suggested that no relationship could be established to support Berman's (2000) contention that the size of the investment could explain FDI in armed conflicts (see appendix 5.10).

Figure 5o. Size of investments (US$ mil) - Afghanistan (2003-2012)



source: FDI Markets

Figure 5p. Size of investments (US$ mil) - Iraq (2003-2010)



source: FDI Markets

5.6.2 Size of investments by conflict intensity

Although the size of the investment was inconsequential to FDI, one possible factor which could explain why 'large' investments were observed during both armed conflicts emerged from reductions in conflict intensity. It has already been determined that FDI continued to flow in Afghanistan and Iraq, and section 5.4.1 established that during the two armed conflicts, the intensity of armed violence fell in certain periods as coalition fatalities and battle related deaths decreased. This indicated that it was possible that 'medium' and 'large' investments were made when the intensity of each armed conflict dropped as this would have reduced the level of risk to the investment.

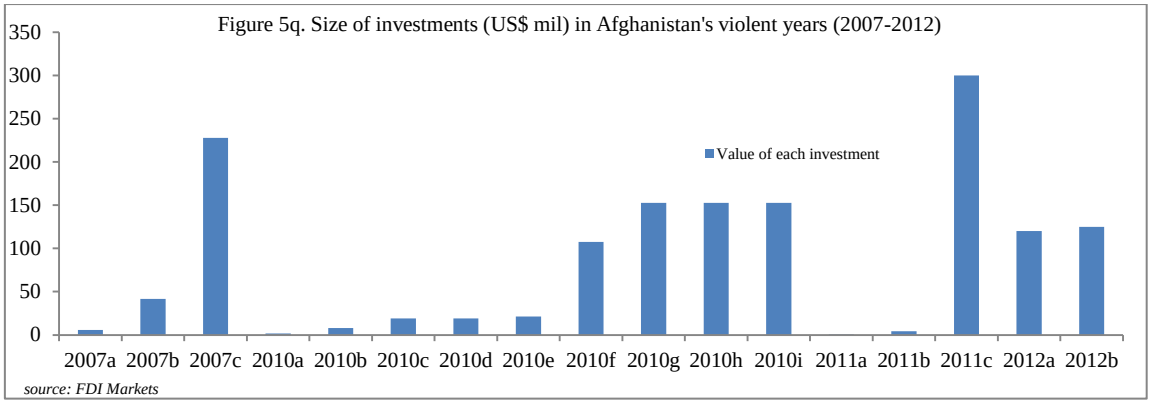
i. Afghanistan

The data in Afghanistan shows that changes in conflict intensity had no effect on the size of each investment as increases in armed violence did not discourage foreign investors from making large investments. This was reflected right from the beginning of its armed conflict as 6 investments were made in 2003 which ranged from $1.4 million to $92.6 million. This included 4 investments which were considered to be of medium to large in size with Lord Krishna and the Punjab National Bank (PNB) making two investments of $41.5 million into the banking sector and Delta International making two investments of $185.2 million into the building and construction sector. Although this

was consistently observed throughout its armed conflict, medium and large investments were more common after 2005 which coincided with a period of high-intensity armed violence as coalition fatalities and battle related deaths started to increase. For instance, Investcome Holding made a $124.8 million investment in the telecommunications sector in 2005 despite the previous two years recording increases in coalition fatalities and battle related deaths, whilst Jiangxi Copper made an investment of $227 million in the extractive sector in 2008 despite the previous five years recording yearly increases in the intensity of armed violence. This trend was further supported by its largest investment of $2.9 billion which was made in 2009 by the China Metallurgical Group Corporation (MSS) despite coalition fatalities increasing by 56% in the same year. This suggested that increase in armed violence did not affect the size of the investments.

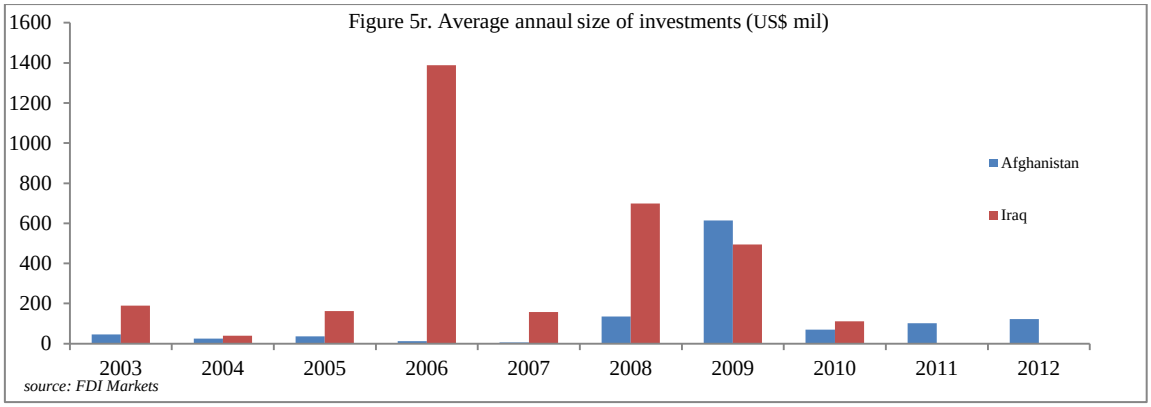
Although the issue of lagged effect could be applied to these investments, the data in coalition fatalities and battle related deaths do qualify what was observed above. Although it is spurious to form a correlation between China Metallurgical Group Corporation's (MSS) investment in 2009 and the 56% increase in coalition fatalities for the same year – due to the lagged effect – the data indicated that the increase in armed violence leading up to the investment did not discourage MSS's decision to make the investment. For instance, every year leading up to 2009 saw an increase in the intensity of armed violence as coalition fatalities increased on average by 48.78%, whilst battle related deaths increased by an average 56.45%.[86] This indicated that MSS was not only making their investment in an armed conflict, but was making its investment in a period where the intensity of armed violence was increasing on a yearly basis.

[86] Although the previous two years in battle related deaths did decrease by an average of 38.67%.



Afghanistan's most violent period in its armed conflict was towards the end of the time frame between 2007 until 2012 which recorded the highest number of fatalities. In this period, it attracted 56% of its total number of investments which were diverse in size. Although the lagged effect could be applied to the size of the investments and its most violent period, the yearly increases in coalition fatalities and battle related deaths from 2003 (as discussed above) should have had a negative effect on every investment made in the latter period, however, the presence of armed violence and the increase in intensity did not discourage foreign investors and did not affect the size of their investments.

The investments in this period were diverse in size with 10 investments falling in the small category which were in the range of $0.1-20 million; 4 investments in the medium category of $20-99.9 million and 9 investments in the $100+ million category. Although the small category attracted the largest proportion of investments (10), the presence of large investments above $100 million (9) provided further proof in support of the earlier observations that the presence of armed conflict and the increase in conflict intensity had no effect on the size of the investments (see appendix 5.6).



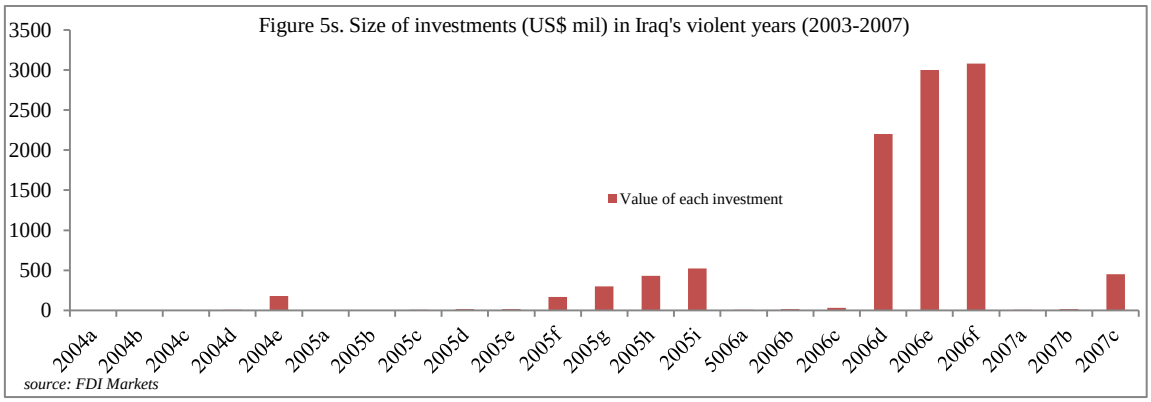
ii. Iraq

The data in Iraq provided further evidence that conflict intensity had no effect on the size of the investment as significant FDI was observed in the first year of armed conflict. In 2003 when armed conflict started, $6,084 billion was invested through 32 investments of which 21 were considered small as they fell below $20 million. The remainder were either of medium or large with 7 investments in the latter category valued in excess of $100 million. This included a £3 billion investment made by John Holland in the real estate sector (see appendix 5.11). Although the economic sanctions which had been placed on Iraq had eased once its armed conflict started, the mere presence of armed violence didn't discourage foreign investor nor did it affect the size of the investments as John Holland's investment in real estate was one of Iraq's largest investments (see appendix 5.11).

After 2003, large investments became more common which paralleled with increases in conflict intensity. This was reflected in its most violent period from 2004 to 2007, which recorded the largest number of coalition fatalities and battle related deaths but also recorded a large number of medium to large investments. In this period, Iraq attracted 56 investments, and although this was fewer than the second period (103) which was relatively less violent, the proportion of large investments was the same as investments above $100 million which represented 32% of total investment for both

periods. In the other categories, small investments were more common during Iraq's most violent period as they represented 60.7% of its total investments compared to the second period which was less violent where it represented 45.7% of its total investments. And in the medium category where investments ranged from $20-999.9 million, investments in its least violent period represented a greater proportion of its total investments (22.3%) compared to the more violent period (7.1%).

Although there was a more intuitive trend in Iraq's FDI as its least violent period (2008-2010) attracted significantly more investments (106) compared to its violent period (56) in 2003-2010, the fact that its investments were made when the previous period saw coalition fatalities increase by an average of 14% and battle related deaths increased by an average of 77.5% suggested that annual increases in armed violence had no effect on foreign investors as they continued to make large investments. For instance, Iraq attracted more investments over $50 million in the 2008-2010 period, which included 10 of Iraq's 16 $1 billion + investments. Although this period was relatively low-intensity, the high-intensity of armed violence in the first period should have discouraged foreign investors as the yearly increases in coalition fatalities and battle related deaths would have been a key deterring factor in their decision making (see appendix 5.11).



5.6.3 Size of investments by province

The previous section has shown that increases in conflict intensity did not affect the size of investments as foreign investors continued to make large investments, however, this was based on the general level of intensity which did not take into consideration that armed violence varied by province. Section 5.4.1 established that each province saw different levels of armed violence which suggests that the size of the investment could be attributed to the intensity of armed violence per province rather than the general intensity of armed conflict.

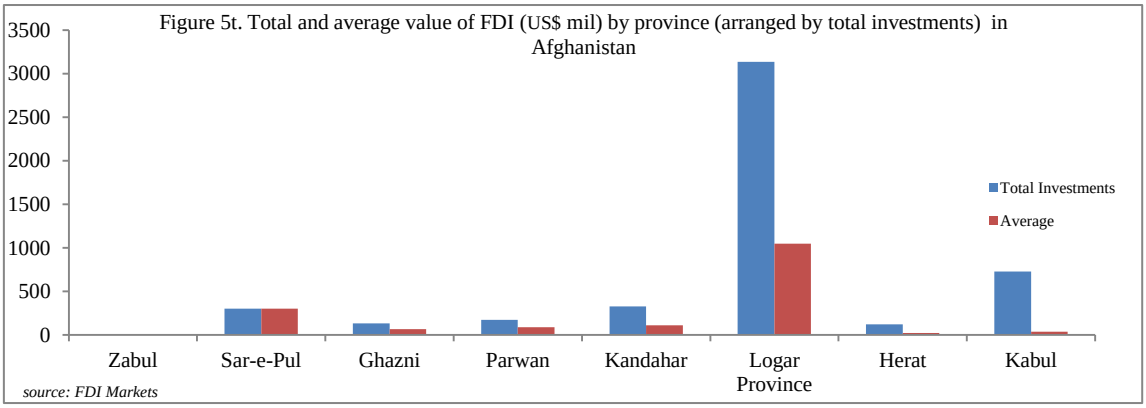
i. Afghanistan

The data in Afghanistan shows that conflict intensity by province had some effect on the size of the investments as the least violent provinces attracted the largest investments. For instance, the Logar province was one of the least affected provinces as it recorded 64 coalition fatalities which reflected in the size of its investments as it attracted two of the three largest investments in the country. The investment by China Metallurgical Group Cooperation (MSS) which was valued at $2.9 billion was the largest investment in Afghanistan, whilst the $227.8 million investment by Jiangxi Copper was the third largest investment. The second largest investment was made by China National Petroleum Corporation (CNPC) in the Sur-e-Pul province which was the only province not to be affected by armed violence. All three investments were made in the natural resource sectors (coal, oil and gas) which suggested a possible correlation between the sector and the size of the investment.

The largest concentration of investments was in the capital, Kabul, which was also the location of the second largest fatalities suffered by occupying forces. Despite the high fatality rate, Kabul attracted investments which ranged in size from the $100,000

investment by Home Essentials to a $120 million investment by the Alokozay Group in real estate. In total, Kabul attracted 21 investments of which 10 were considered small, 9 were considered medium and 2 were considered large. This suggested a possible correlation between conflict intensity and the size of the investment as there were fewer medium and large investments; however, this was not supported by investments throughout the country as Kandahar showed that high-intensity did not lead to a reduction in the size of its investments as the majority of its investments were in the large investment size category. This was illustrated by Move One making two large investments of $152.8 million in the transportation sector (see appendix 5.7).

Figure 5t. Total and average value of FDI (US$ mil) by province (arranged by total investments) in Afghanistan



source: FDI Markets

ii. Iraq

The data in Iraq supports the findings in Afghanistan as it too shows that conflict intensity by province had some effect on the size of investments, although large investments were observed in provinces which had a high concentration of armed violence. The data shows that the most violent provinces which included Al Anbar and the capital Baghdad managed to attract significantly large investments with Al Anbar attracting 8 investments of which 5 were over $100 million which included two investments of over $1.4 billion from Dana Gas and ONGC Videsh Limited (OVL) into the natural resource sector (coal, oil and natural gas). In Baghdad, foreign investors

were equally as adventurous as small, medium and large investments were continually made throughout its armed conflict.

Baghdad saw the largest concentration of investments (53) of which the majority (37) were considered small, with 9 in the medium category and 7 in the large category which included 3 above $1 billion. This included John Holland's and Bonyan International's $3 billion investment in real estate and the largest single investment in Iraq when Al Maabar International made a $10 billion investment also in real estate. The data from Baghdad indicated that as the size of the investment increased, the frequency of the investment decreased which suggested that foreign investors were willing to make small investments as these presented fewer losses in the event the investment was lost or destroyed. This was supported by investments in the Erbil province which attracted 34 investments. Although the level of armed violence in Erbil was not on par with Baghdad, Erbil showed a decrease in the frequency of its investments as the size of the investment increased. This was reflected in the data as 55% of its investments were considered small as they fell below $20 million; 23% were considered medium ($20-99.9 million) and 20% were considered to be large ($100 million +). The results from Baghdad and Erbil supported the results from Kabul.

Although it appeared that a correlation existed between conflict intensity and the size of the investment, the remaining data suggested that this relationship could not be replicated across all the provinces. For instance, the province of Al Basra had a higher level of armed violence compared to Erbil but it also attracted more medium to large investments as 58% (13) of its total investments (21) were above $20 million. However, when dissecting its investments, it emerged that all of its large investments were concentrated in the natural resource (coal, oil and natural gas) or the real estate sector, which suggested a possible correlation between sector and the size of the investment.

The remaining provinces which saw different levels of conflict intensity supported the findings in Al Basra. These provinces included Sala Ad Din, As Sulaimaniyah, Dahuk and Ninawa which initially struggled to attract FDI, however, the solitary investments that it did manage to attract were 'large' in size and located in either the building construction, business, natural resources or real estate sectors (see appendix 5.12).

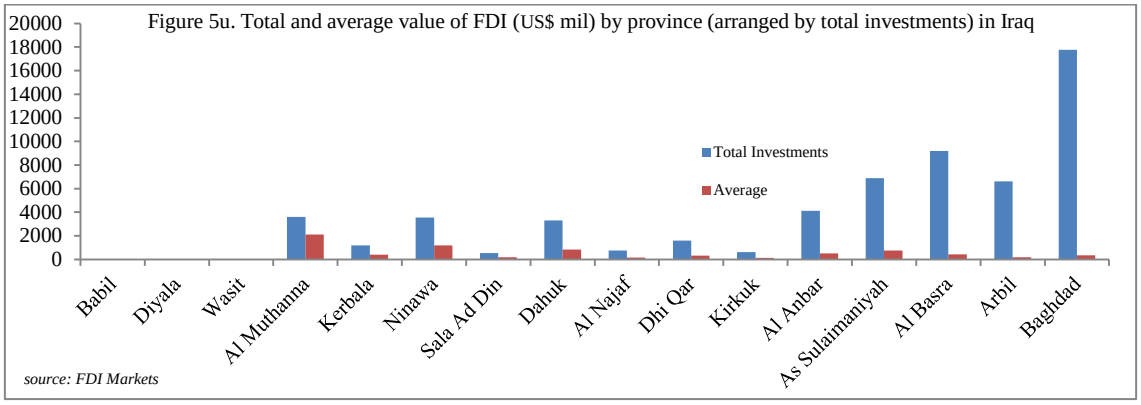


Figure 5u. Total and average value of FDI (US$ mil) by province (arranged by total investments) in Iraq

5.6.4 FDI by sector

The data from the previous section has shown that province had some effect on the size of the investment, although it started to emerge that sector and the size of the investment were positively linked. The data suggested that the natural resource and real estate sectors continued to attract large investments even though they required intense capital which went against Berman's (2000) assertion that capital intensive sectors struggle to attract FDI.

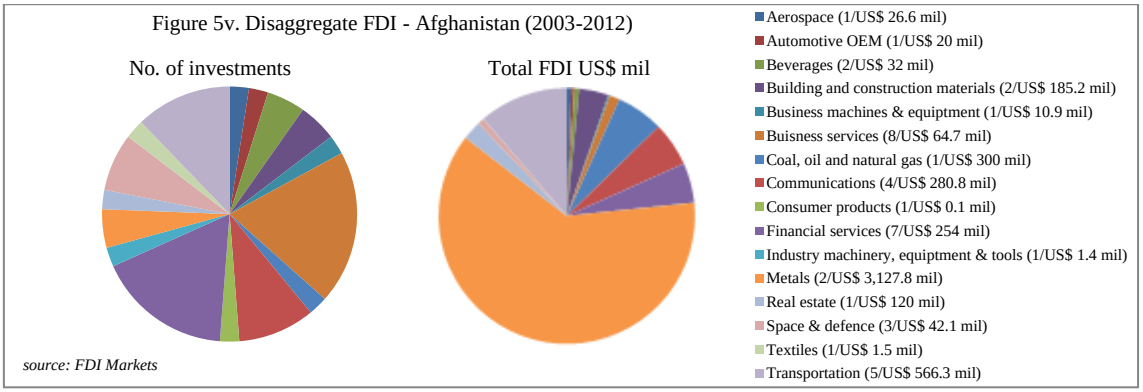
i. Afghanistan

The data indicates that FDI was not sector specific as investments were observed in capital intensive and less intensive sectors – this included the natural resource and the non-resource sectors. In Afghanistan, foreign investments were made in 18 sectors, whilst in Iraq foreign investments were made in 20 sectors. The data for both case studies showed that capital intensive sectors attracted the largest volume of FDI, whilst

the least capital intensive sectors attracted the largest number of foreign investments (see appendix 5.8 & 5.13).

In Afghanistan, the business services and financial services sector attracted the largest number of foreign investors with 8 investments carried out in business and 7 in financial services. The business services sector attracted $64.7 million of FDI with financial services attracting $254 million. Although they attracted the largest number of investments, the actual volume of FDI represented only 6.28% of Afghanistan's total FDI. These two sectors joined consumer products ($0.1 mil), textiles ($1.5 million) and space and defence ($14.03 million) in attracting the least amount of FDI. The low levels of FDI in these sectors could be explained by either: (i) the limited opportunities that exist in these sectors; (ii) the underdevelopment of these sectors; or (iii) the difficulty in entering these sectors (see appendix 5.15).[87]

Figure 5v. Disaggregate FDI - Afghanistan (2003-2012)



source: FDI Markets

As expected, capital intensive sectors attracted the largest volume of FDI with a lower frequency of investments. This was consistent with the claims in the literature that capital intensive sectors are infrequent in armed conflicts as they incur greater losses; however, capital intensive sectors are also infrequent in proportion to total investments in peace time due to the high levels of resources required to enter these sectors. Metal

[87] The investment in the business and financial services sector were located in Kabul (11), Gazni (1) and Herat (3). This perhaps indicates a link between the location of the investment and sector as business and financial services are often located in commercial cities.

extraction attracted the largest volume of FDI as 2 investments in this sector represented 62% of Afghanistan's total FDI. This included Jiangxi Copper's $227.8 million investment and China Metallurgical Group Corporation's (MCC) $2.9 billion investment in extracting metal from the Logar Province. The two large investments were expected because of the high value commercial benefits of natural resources. The coal, oil and natural gas sector also attracted FDI, although the size of the investment was relatively less compared to metal extraction. The 1 investment of $300 million by China Natural Petroleum (CNPC) in the Sur-e-Pul province was the only investment in this type of resource which indicated either foreign investor's unwillingness to make large investments or Afghanistan's limited resource availability. Nevertheless, the level of investments made in the natural resource sectors significantly outperformed the level of investments in the non-resource sectors as FDI in coal, oil, natural gas and metal extraction represented just over 68% of Afghanistan's total FDI.

The non-resource capital intensive sectors also attracted FDI with transport attracting $566 million and telecommunications attracting $280.8 million of investment, however, as a percentage of total FDI, it represented only 16%. Although FDI into the transport sector was relatively small, the size of each investment was considerably large as 5 investments were carried out with an average investment of $113.26 million. This confirmed that the transport sector was capital intensive which was supported by disaggregated FDI data. This revealed that the size of each investment ranged from a $107.5 million investment in Kabul's transport infrastructure by TTL Shipping and Logistics to 4 investments of $114 million by Move One in the Herat, Kandahar (2) and Parwan provinces. In terms of capital requirements, the transportation sector was the fourth largest capital intensive sector behind metal extraction ($1.56 billion), coal, oil and natural gas ($300 million) and real estate ($120 million).

The telecommunications sector was expected to attract more investment compared to the transport sector, however, the transport sector outperformed telecommunications by attracting almost 100% more FDI. Although both sectors are capital intensive, the telecommunications sector is often seen as having a significant advantage over the transport sector in armed conflicts due to the limited requirements for fixed physical assets and the high value of accessing news and information which reduces its vulnerability to asset destruction and asset theft, as well as reducing its sensitivity towards domestic demand shocks. [88] Although the telecommunications sector outperformed the transport sector, its level of investment represented only 5.57% ($280.8 million) of the country's total FDI, making it the 4th largest sector.

FDI in the telecommunications sector revealed some interesting insights on the geographic origin of the investors and the size of the investment. The data indicated that the largest investments in this sector came from neighbouring or regional countries as Investcom Holding of Lebanon and Etisalat from the UAE made an investment of $249.8 million which represented 79% of total telecommunications FDI ($260.8 million). The remaining investments were comparatively small and came from the German telecommunications company Siemens and US entertainment company Walt Disney who combined made an investment of $31 million which represented only 11% of total FDI in this sector. This suggested that the size of the investment correlated with the origin of the investment as investors took advantage of the 'near home bias'. This was further supported by the data in the business and financial services sector where the larger investments originated from neighbouring or regional countries.

[88] As armed conflict increases the value of accessing news and information which can be obtained relatively cheaply through cellular networks (see Henkel and Heeks 2009)88, and phone masts can be set up in protected areas with headquarters located in neighbouring countries (see MIGA 2010), investors seeking to operate in this sector are often attracted to its ability to minimise its commercial exposure to conflict affected risks. And according to the World Bank, mobile phone companies are quick to set up operations in conflict and post-conflict countries to the extent that their presence is an indicator of private sector recovery (see Schwartz el al. 2004, p. 13).

Traces of FDI were also observed in other sectors although these were solitary investments relatively on a smaller scale. This included Airfreight Aviation's (UAE) $26.6 million investment in the aerospace industry, Coca Cola's $64 million investment in beverages, Heidelberger's (Germany) $10.9 million investment in business machines & equipment and Alaska Structure's (US) $1.5 million investment in textiles.

ii. Iraq

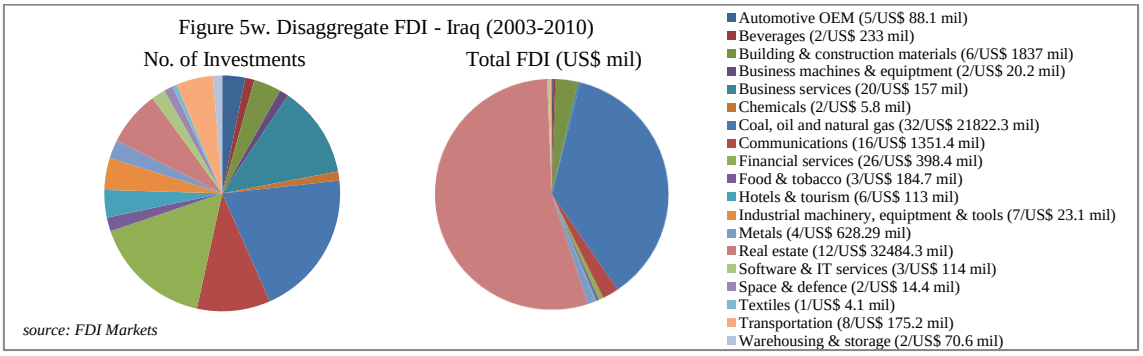
The disaggregate FDI data in Iraq followed a similar pattern to that of Afghanistan as investments in capital intensive sectors were consistent throughout its armed conflict. The majority of Iraq's investments were located in its natural resource sector (coal, oil, natural gas and metals) which attracted 34 investments totalling over $22.4 billion which represented 38% of the country's total FDI. This was in stark contrast with Afghanistan where the business and financial services sector attracted the largest number of investments, and where its FDI in the natural resource sector represented a larger proportion of its total FDI (68%).

The high volume of FDI in the natural resource sector was expected due to the sectors insensitivity towards asset destruction and domestic demand shocks; however, it emerged that the real estate sector was the largest recipient of FDI in Iraq as total investment exceeded $32.48 billion which represented 54% of its total FDI. Although it was expected that the real estate sector would attract a larger proportion of total FDI, during armed conflict its level of investment was expected to fall due to its vulnerability towards asset destruction and domestic demand shocks, and although this was not evident in Iraq, it was evident in Afghanistan as FDI in real estate represented only 2.38% of its total FDI.

The real estate and the natural resource sectors were also the most capital intense sectors as the average size of their investments was the largest. In Afghanistan, the natural resource sector required the most capital as average investment was $1,142 billion, with real estate ranked second with average investment of $120 million. Although in Iraq, real estate was the most capital intense with average investment of $2.7 billion, the natural resource sector also required heavy investment as average investment was $623 million. These large investments were not uncommon as the data showed that Iraq attracted large investments in other capital intensive sectors included building and construction materials ($306 million), beverages ($116.5 million) and telecommunications ($84.46 million); whilst Afghanistan attracted large investments in transportation ($114.2 million), building construction materials ($92.6 million) and telecommunications ($70.2 million).

Although these sectors necessity for intense capital explains their level of investment, the presence of armed violence should have discouraged foreign investors from making large investments as the size of the investment would have represented greater losses. Although FDI in the natural resource sector could be explained by its ability to reduce its vulnerability towards asset destruction and domestic demand shocks, these conflict affected risks should have applied to the non-resource capital intensive sectors which would have inevitably increased the level of risk to the investment.

Figure 5w. Disaggregate FDI - Iraq (2003-2010)



source: FDI Markets

There were some similarities in FDI for both case studies as it emerged that the large volume of FDI in the real estate sector had a positive effect in the building & construction materials sector. In Iraq, the intense investment in its real estate sector led to its building & construction materials sector attracting $1,837 billion whilst in Afghanistan, this sector attracted $185.2 million. Although the size the FDI varied significantly, each countries investment in building and construction materials represented almost 3% of their total FDI which made it the third largest sector for FDI in Iraq and the sixth in Afghanistan.

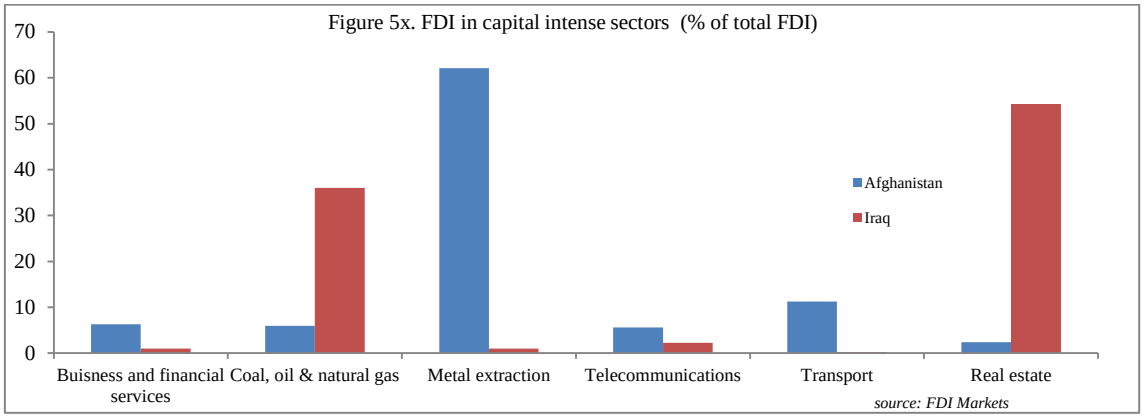
There were also similar trends in the telecommunications sector which emerged as the fourth and fifth biggest sector for FDI in Iraq and Afghanistan. Although the level of FDI varied significantly as Iraq attracted $1.35 billion whilst Afghanistan attracted only $380 million, their investments in proportion to total FDI was fairly similar as Iraq's investment represented 2.2% of total FDI and Afghanistan's represented 5% of total FDI. This similarity did not apply to the transport sector as the level of investment differed in volume and proportion as Afghanistan attracted $566 million (11% of total FDI) which made it the second largest sector, whilst Iraq attracted $175 million (1% of total FDI) which made it one of the smallest sectors for investment. This disparity probably indicated that Afghanistan transportation infrastructure offered more opportunities for foreign investors or that it required a higher level of investment for development. The latter, was partially supported by the capital requirements of each investment as Afghanistan's average investment ($113.26 million) in this sector was higher compared to Iraq ($21.9 million).

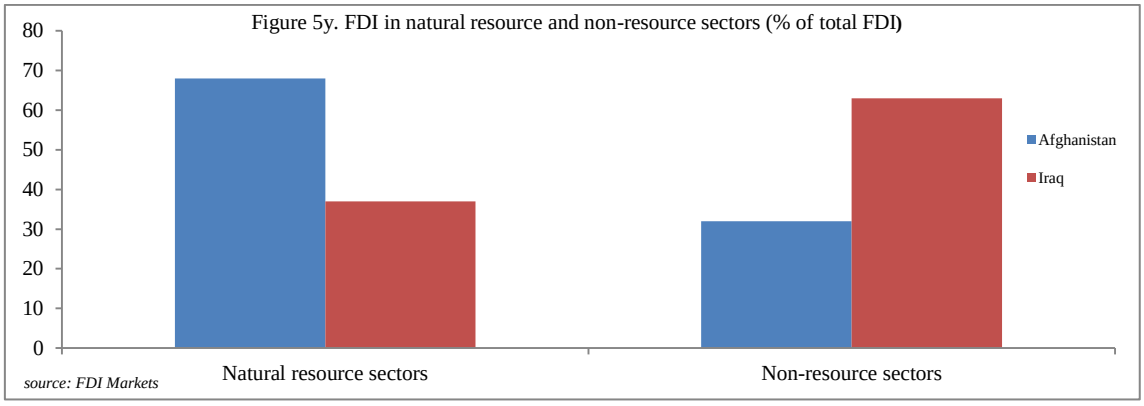
The earlier section established that 'near home bias' (see Levis et al. 2010, p. 3) was influential in Afghanistan's telecommunications sector as the two largest investments originated from neighbouring/regional countries (Lebanon and the UAE) whilst the two

smallest investments came from countries further afield (Germany and the US). A similar trend was also evident in Iraq as its largest investment emerged from a neighbouring/regional country (Kuwait) with 2 of its 3 smallest investments coming from countries further afield (Czech Republic and the US). However, the trend didn't run consistently in this sector as 3 of Iraq's largest 5 investments in the telecommunications sector came from non-regional/neighbouring countries (France, Sweden and the US), with 5 of the 10 smallest investments also coming from regional/neighbouring countries (Bahrain, Egypt, Kuwait and 2 from the UAE). Although the size of the investments in the telecommunications sector could not be wholly attributable to the 'near home bias' in Iraq, investments in the coal, oil and natural gas, financial services, food and tobacco, and hotels and tourism sectors could, as the largest investments came from neighbouring/regional countries, whilst in Afghanistan, the 'near home bias' influenced investments in the business and construction materials, business services, and the transportation sectors.

There was also an alternative explanation on the origin of the investment which emerged from investments which were tied to the external military intervention (EMI). Although in the telecommunications sector, the largest investments emerged from a neighbouring/regional country, some of the largest investments also came from investors who were tied to the EMI as the second largest investments in this sector came from the US with the second largest investment in real estate coming from the UK. Although these were not the largest investments in these sectors, countries which intervened militarily dominated the investment climate in the business services sector in Iraq and space and defence in Afghanistan, whilst its presence was also felt in other sectors. This suggested that foreign investors were also taking advantage of their

countries military presence by 'following the flag' (see Biglaiser and Derouen 2007, p. 836).





The traditionally less capital intense sectors which included business and financial services also attracted FDI. In Afghanistan, business services attracted the largest number of investments and although in Iraq, coal, oil & natural gas attracted the most investments (32), business and financial services were the second and third most invested sectors. Despite these successes, the volume of FDI was comparatively low as Iraq's FDI in these sectors amounted to $555.4 million which represented 0.92% of its total FDI, whilst in Afghanistan; its total FDI for these sectors was $318.7 million which represented 6.28% of its total FDI.

And finally there was one more trend which emerged by looking at FDI by sector. This showed that the capital cities in Afghanistan and Iraq were the ideal location for

investments into the business and financial services sector. The data showed that 11 of Afghanistan's 15 investments (73%) in business and financial services were located in Kabul, whilst 20 of Iraq's 45 investments (44%) in these sectors were located in Baghdad. Similar trends were also evident in the natural resources and transportation sector in Afghanistan and natural resources, industrial/machinery/equipment and tools, and the software and IT services sectors in Iraq. This suggested a possible link between the sector and the location of the investment.

Traces of FDI were also observed in other capital intense and less capital intense sectors, although the level of investment was considerably 'small'. This included hotel & tourism ($113 million), automotive ($88 million), food & tobacco ($177.7 million), industrial machinery, equipment & tools ($23.1 million), space and defence ($14.4 million) and warehousing ($70.6 million) (see appendix 5.12).

5.7 'Following the flag' or 'near home bias'

The analysis from the above investigation clearly indicates that FDI was distributed across the sectors including the capital intense/less intense and natural resource/and non-resource sectors. When looking at the origin of the investments, it started to emerge that two factors determined FDI; this included FDI which 'followed the flag' (see Biglaiser and Derouen 2007, p. 836) and FDI which could be tied to the geographic proximity of the investor through the 'near home bias' factor (see Levis et al. 2010, p. 3).

i. Afghanistan

FDI in Afghanistan originated from 14 countries which were split between: (i) investors who 'followed the flag' as their countries participated in the external military intervention (EMI); (ii) investors who had a 'near home bias' because their countries

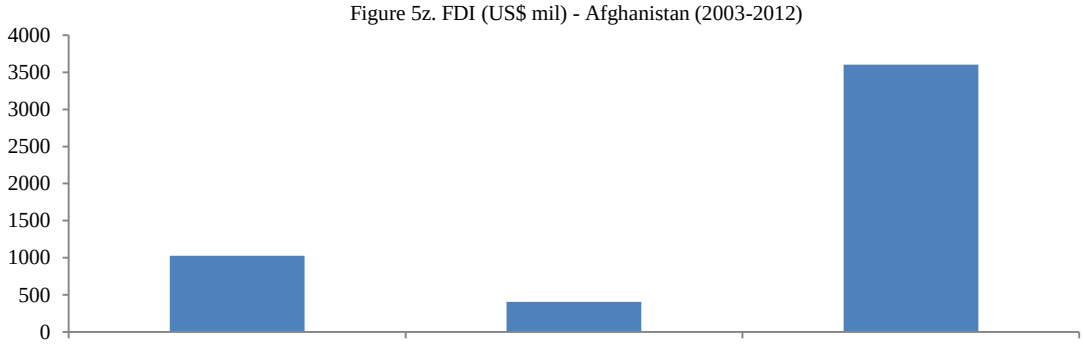
either shared a border or were located in the same region but did not intervene militarily; and (iii) investors who originated from countries which didn't have any connection to either 'following the flag' or 'near home bias'. From the 14 countries which invested in Afghanistan, 5 countries participated in the EMI by contributing 'boots on the ground' to NATO's International Security Assistance Force (ISAF); 4 countries were considered as either sharing a territorial border or coming from the same region and 5 countries did not fit in either of the two categories. The countries which intervened with 'boots on the ground' included Germany, Ireland, UAE, UK and the US and the investors which followed their country into Afghanistan were considered as 'following the flag'. Investments from India, Iran, Kyrgyzstan and Pakistan were considered as having a 'near home bias' as Iran and Pakistan share a territorial border whilst India and Kyrgyzstan are from the same region. Jordan and Lebanon could also have been included in this group as they share similar religious characteristics but as they dod not share a territorial border, nor are they in the same region, investments from these countries were grouped as 'other' which also featured China, Hong Kong and Russia.

The data indicated that the largest volume of FDI came from the group of countries which did not 'follow the flag' nor were influenced by the 'near home bias'. This group which included China, Hong Kong, Jordan, Lebanon and Russia invested almost $3,602.2 billion in Afghanistan which represented 71% of its total FDI. FDI from the 'following the flag' group invested $1,025.3 billion, whilst countries from the 'near home bias' group made the least amount of investments with $405.9 million. FDI between the latter 2 groups accounted for 28% of Afghanistan's total FDI with 'following the flag' representing 20% and 'near home bias' representing 8% of Afghanistan's total FDI. This suggested that 'following the flag' and 'near home bias'

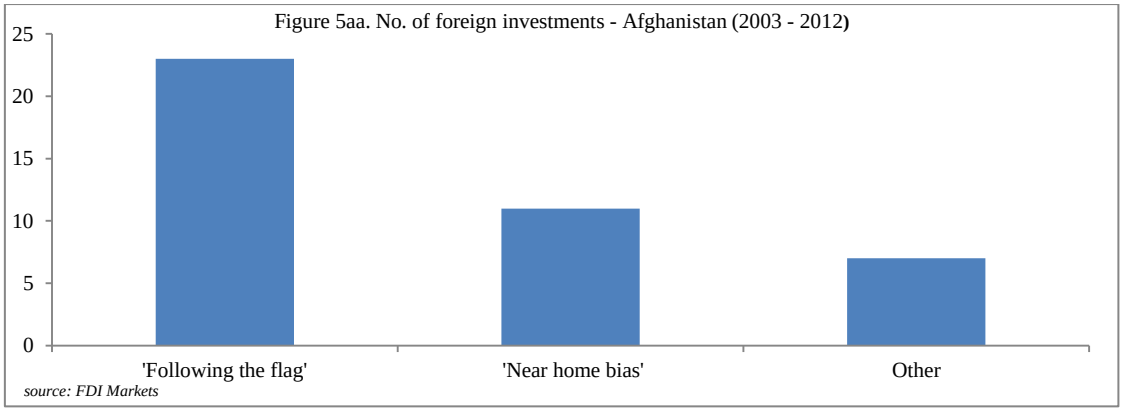
was not relevant in Afghanistan as the majority of its FDI came from countries which had no military involvement or had any geographic connection with the host country.

The ‘following the flag’ and ‘near home bias’ were more relevant when looking at the number of foreign investments which were carried out in Afghanistan. Countries which intervened in the Afghan civil war from 2003 made 23 investments which came from Germany (3), Ireland (1), UAE (8), UK (4) and the US (7) which represented 56.1% of total investments in Afghanistan (44). The ‘near home bias’ contributed 11 investments which accounted for 26.8% and was made up of investments from India (4), Iran (3), Kyrgyzstan (2) and Pakistan (2). Combined, the ‘following the flag’ and the ‘near home bias’ accounted for 34 investments (82.9%) with countries which had no connection to either group contributing 7 investments (17.1%). This included 3 investments from China and solitary investments from Hong Kong, Jordan, Lebanon and Russia.

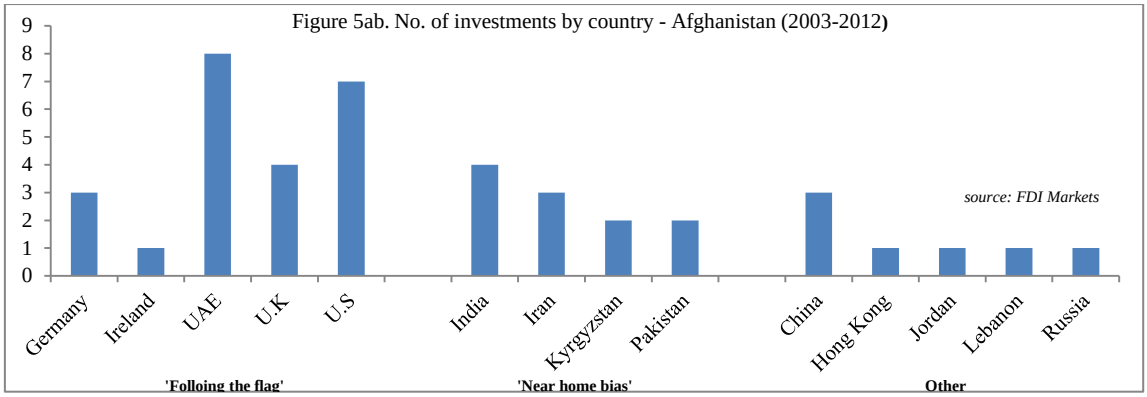
Figure 5z. FDI (US$ mil) - Afghanistan (2003-2012)



source: FDI Markets



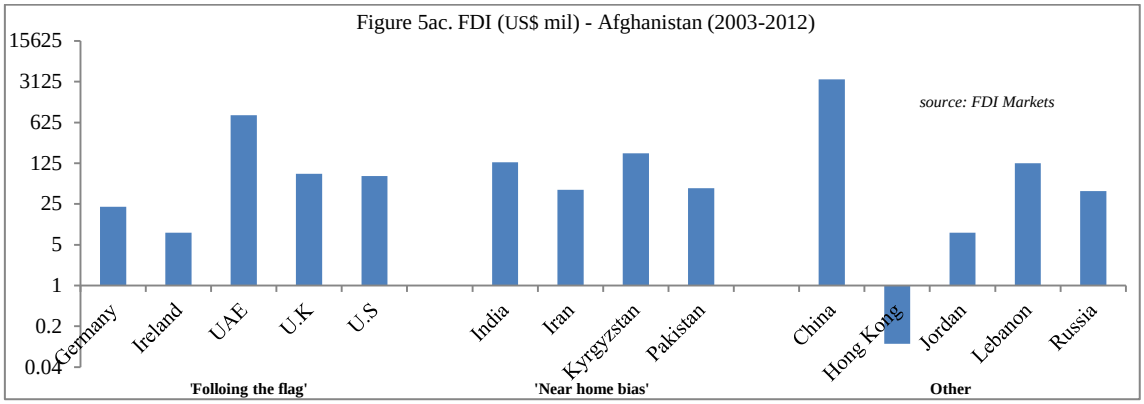
China was the largest investor in Afghanistan with $3,427.8 billion of FDI which was made through 3 investments including 2 in the country's natural resource sector. This included an investment of $2.9 billion which was the single largest investment in Afghanistan by the China Metallurgical Group Corporation (MCC) in metals extraction whilst China National Petroleum (CNPC) made a $300 million investment in the coal, oil and natural gas sector which was the second largest investment. The UAE was the second largest investor in Afghanistan with $837.7 million. This was distributed amongst the non-resource primary sectors including 5 investments in the transportation sector of $565.94 million and 1 in aerospace ($26.6 million), real estate ($120 million) and telecommunications ($124.8 million). Kyrgyzstan was the third largest investor by volume with a $185.2 million investment in the building and construction materials sector; however, this was through 2 investments. India was the fourth largest investor with FDI of $130.4 million which dominated the business and financial services sector and Lebanon came fifth with an investment of $124.8 million in the telecommunications sector.



The UAE was the second largest investor with FDI of $837.7 million but it was also the destination from which the most investment was made. From Afghanistan's total of 41 investments, 8 originated from the UAE, with the US (7) coming second and the UK (4) third. Despite the US and the UK's high position, the total volume of FDI from these two military intervening countries was smaller than the total volume of FDI from Lebanon which made only 1 investment of $124.8. FDI from the US was $75 million which was predominately in the less capital intensive sectors such as beverages and textiles, whilst FDI from the UK of $82.3 million was located in the business services and space & defence sector.

The composition of the external military intervention in Afghanistan showed that the US was the biggest contributor of 'boots on the ground' with 68,000 troops, with smaller contributions made by the UK (8,065), Germany (4,400), the UAE (35) and Ireland (7) (see ISAF 2013). Although the external military intervention consisted of predominately US troops, this did not reflect its FDI which suggested that the size of the military intervention did not correlate with total and volume of FDI. The UAE was one of the smallest contributors to the EMI, but led in FDI with the largest number of investment projects (8) and largest volume of FDI ($837.7 million) with the US making only 7 investments totally $75 million, and the UK with 4 investments totalling $82.3

million. From this data it was certain that no link existed between troop contributions to the volume and the number of investments in Afghanistan (see appendix 5.9).

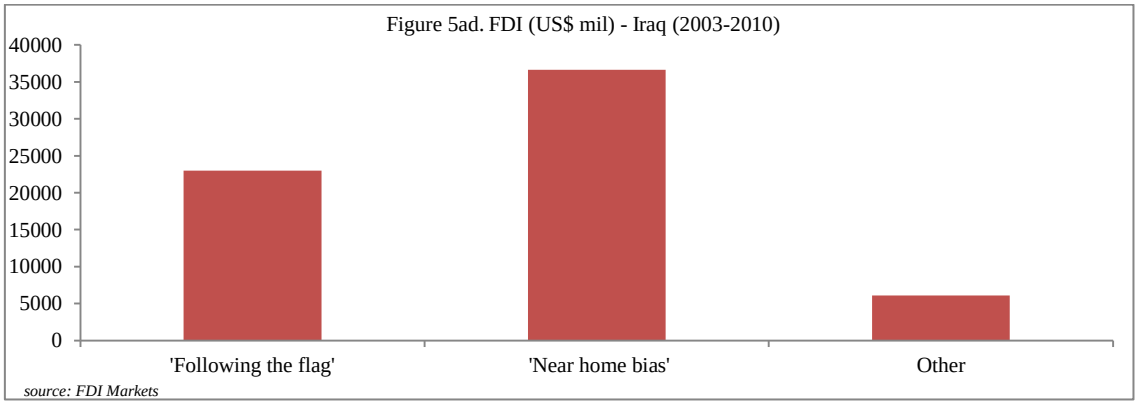


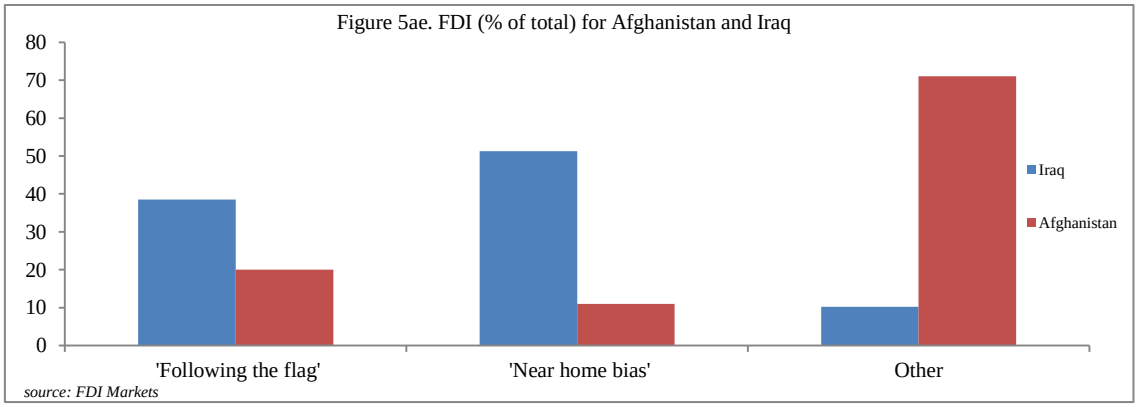
Data in logarithmic scale (5)

ii. Iraq

Iraq received FDI from 35 countries which were separated into the same three groups as Afghanistan. The first group included investments from 12 countries which intervened military; the second group included investments from 9 countries which had a territorial connection with Iraq; and the final group belonged to 14 countries which neither had any affiliation to the external military intervention nor were territorially connected to the host destination. The countries which intervened militarily included Australia, Czech Republic, Denmark, Latvia, Netherlands, New Zealand, S. Korea, Spain, Thailand, UK, Ukraine and the US, and investments from these countries were considered as 'following the flag'. Investments from Bahrain, Egypt, Iran, Jordan, Kuwait, Lebanon, Saudi Arabia, Turkey and the UAE, were considered as having a 'near home bias' as they either shared a territorial border or came from the same region. And the final group included Austria, Bermuda, Canada, France, Germany, Greece, India, Indonesia, Ireland, Japan, Luxembourg, Russia, Slovenia and Sweden, which had no affiliation with the EMI or had any territorial connection with Iraq.

The data indicated that the largest volume of FDI came from countries which had a 'near home bias' as investment from this group totalled $36,636.1 billion which represented 51.3% of Iraq's total FDI. 'Following the flag' was the second largest contributor as $23,004 billion of investment originated from countries which participated in the external military intervention which represented 38.5% of its total FDI with $6,084.79 (10.2%) coming from the remaining countries. The data suggested that countries which had a territorial connection with Iraq or were part of its EMI dominated its investment climate as these two groups represented over 89.8 % of its total FDI. This was in stark contrast to Afghanistan where investments from these two groups represented only 31% of its total FDI (see appendix 5.17).





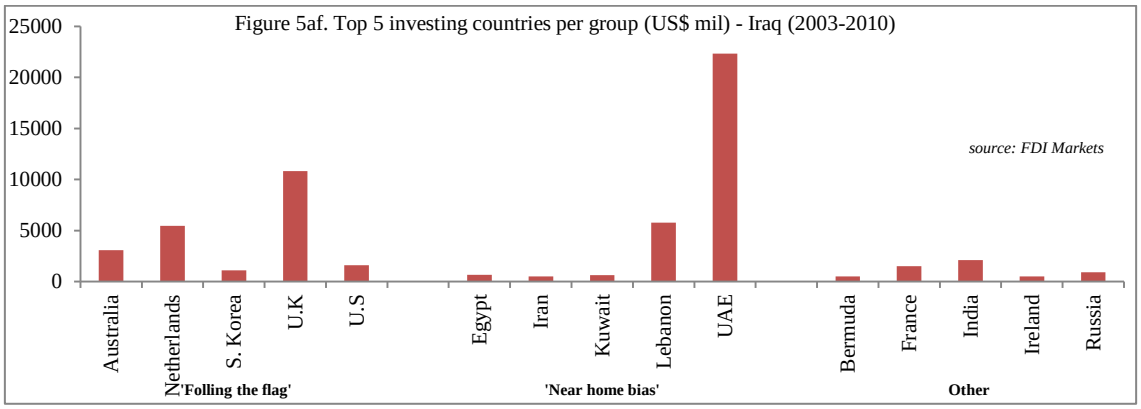
The 'following the flag' and 'near home bias' also dominated the number of investments Iraq received which was consistent with the observations in Afghanistan. In Afghanistan, a large number of investments originated from countries which

participated in the external military intervention with 23 (56.1%) out of a total of 41 investments coming from this group, whilst the 'near home bias' influenced 11 (26.8%) investments. In total, 'following the flag' and 'near home bias' attracted 34 (82.9%) investments with 7 (17.1%) investments coming from countries which neither intervened nor were geographically connected to the host destination. In Iraq, it was the 'near home bias' which contributed the largest number of investments as 62 investments (38.99%) came from neighbouring or regional countries with 56 (35.22%) investments coming from countries which participated in its armed conflict. And although 41 (25.8%) investments came from the 'other' group, which in Iraq represented a greater proportion compared to Afghanistan, 74.21% of its total investments came from either 'following the flag' or 'near home bias'. By looking at this data, it was clear that 'following the flag' and 'near home bias' dominated the investment climate in Afghanistan and Iraq as it facilitated the greater number of foreign investments, however, their influence did not extend to dominating the investment climate in terms of total FDI (see figure 5ae).[89]

The top 5 investors in Iraq by volume of FDI came from countries which either participated in the external military intervention or had a geographic connection to the host destination. The UAE was the largest investor in Iraq as its investors took advantage of the 'near home bias' by making over $22,317.8 billion of investments. This was carried out through 20 investments which were concentrated in the business services, coal, oil and natural gas, communications and real estate sectors. The UK which had a large military presence in the country was the second largest investor with investments of $10,824 billion which were concentrated in the coal, oil and natural gas

[89]Although 'following the flag' and 'near home bias' accounted for the largest share of investments in the two armed conflicts, investments from the UAE, UK and the US combined represented 45.99 % of total foreign investments in Iraq which was equivalent to 73 investments out of a total of 159. In Afghanistan the same three countries made 19 investments from a total of 41 which represented 46% of total investments.

sectors. Despite both countries investing in the natural resource sectors, 85% of their total FDI was concentrated in real estate with the natural resource sectors of coal, oil and natural gas and metal extraction representing fewer than 13% of their total FDI. Lebanon was the third largest investor with $5,762.6 billion with the Netherlands and Australia the fourth and fifth largest investor with $5,467 billion and $3,079.3 billion of investments which were predominately located in the real estate, and coal, oil and natural gas sectors.



The trend observed in Iraq differed slightly in Afghanistan where China was the largest investor with investments of $3,427.8 billion which represented 68% of Afghanistan's total FDI. Apart from this, there were two similarities that emerged when looking at the origin of the FDI. The first similarity was the UAE's domination of the investment climate as it was the largest investor in Iraq with FDI of $22,317.8 billion and the second largest investor in Afghanistan with FDI of $837.7 million. Its FDI accounted for 38% and 16.6% of each country's total FDI. The second similarity which followed on from the UAE's domination of the investment climate showed that the largest investors either originated from countries which were part of the external military intervention or emerged from countries which had a geographic connection with the host destination. In Iraq, the top 5 investing countries by volume were the UAE, UK, Lebanon, Netherlands and Australia, with the UAE and Lebanon having a geographic

connection with Iraq, whilst the UK, Netherlands and Australia intervened in Iraq's armed conflict. In Afghanistan, this was slightly different as only 2 of the top 5 investing countries emerged from either the 'following the flag' or 'near home bias' group. This included the UAE and Kyrgyzstan; with the UAE sending troops and Kyrgyzstan of the same region as Afghanistan. Although the remaining 3 countries (China, India and Lebanon) had no affiliation with the EMI nor did they have any geographic connection with Afghanistan, the trend which emerged showed that the biggest investors in both armed conflicts either 'followed the flag' or took advantage of the 'near home bias'.

It would seem that if 'following the flag' is influential in attracting FDI, then there would be a logical relationship between military contribution and the size of their investments. For instance, the US was the single largest contributor of 'boots on the ground' in Afghanistan and Iraq; however, its military presence did not reflect in its FDI as it was modest compared to countries which contributed fewer troops. In Afghanistan, the US contributed 68,000 'boots on the ground' (see ISAF 2003) with an additional 166,300 in Iraq (see Carney 2011) and despite its large presence; US FDI into Afghanistan was $75 million whilst in Iraq it was $1,603.9 billion. This compared poorly with the UAE who made more investments in both armed conflicts with fewer troops. The UAE was the second largest investor in Afghanistan with $837.7 million despite sending only 35 'boots on the ground', whilst in Iraq it was the single largest investor with investments totalling $22,317.8 billion, even though it had a non-interventionist policy in Iraq's armed conflict.

The UAE's domination of Afghanistan and Iraq's investment climate suggested that there was no clear relationship between military contribution to the size of its FDI, and

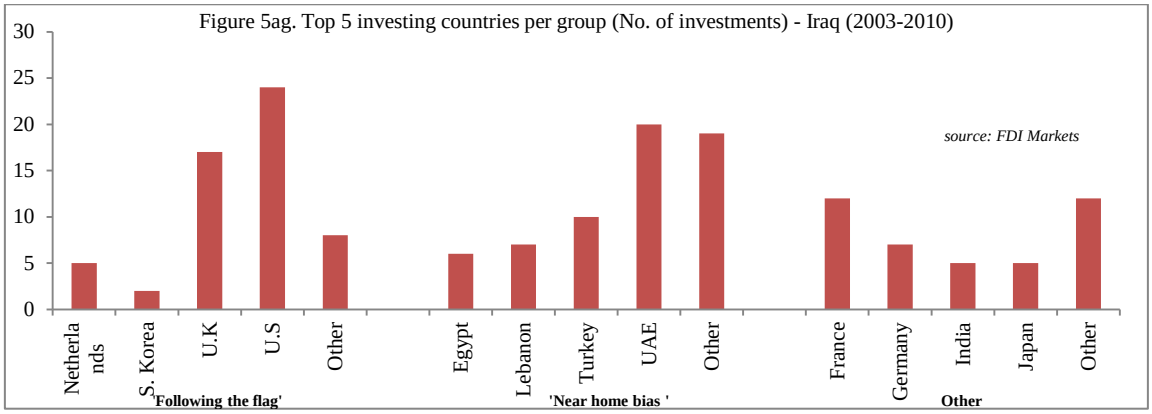
this was further supported by analysing UK military contribution to the size of its FDI.[90] The UK was the second largest military contributor in both armed conflicts and although it took advantage of its significant deployment in Iraq by becoming the second largest investor with investments of $10,824 billion, its level of FDI in Afghanistan did not reflect its large military contribution. In Iraq, UK FDI represented 18% of its total FDI, whereas in Afghanistan, UK FDI represented only 1.6% its total FDI. Although Afghanistan attracted less FDI compared to Iraq, UK FDI was even below FDI from the UAE and from Lebanon, however, as the UAE took advantage of its small military presence in Afghanistan, Lebanon had no significant advantage as it neither participated in the Afghan civil conflict nor had any territorial connection with it. The trend here provided further strength to the above conclusion that military contribution did not affect the size of its FDI.

Although the UK and the US did not dominate the investment climate, their large military presence did see more individual investments arriving from their countries into the host destinations. This suggested that a possible relationship existed between the military contributions to the number of investments each country made. For instance, more foreign investors arrived from the US than anywhere else in Iraq including the UAE which was the largest investor in the country. Despite it dominating the investment climate, the UAE had 20 investments whereas the US had 24 and as the UK was the second largest military contributor, it also carried out 17 investments making it the third largest investor in terms of the number of investments. This was also consistent in Afghanistan where the UK made 4 investments and the US 7, however, despite their high positions, the possibility of a link between military contribution and the number of investments appeared spurious as the UAE once again dominated the investment

[90] The UK contributed 8,065 'boots on the ground' in Afghanistan (see ISAF 2013) and 46,000 'boots on the ground' in Iraq (see CNN, October 13, 2009).

climate in Afghanistan. This confirmed that military contribution did not lead to the UK and the US dominating the investment climate in terms of total FDI or in the number of investments.

Figure 5ag. Top 5 investing countries per group (No. of investments) - Iraq (2003-2010)



Contributing ‘boots on the ground’ as well as having a geographic connection to the host destination seemed to have a positive effect on the size of investments. In the theoretical arguments, the size of an investment is a determinant of FDI as intuitively large investments carry far greater commercial and non-commercial risks compared to smaller investments. In section 5.5.1, the data indicated that large investments were frequently observed in Afghanistan and Iraq, which suggested that foreign investors were prepared to make large investments despite the risks. Looking at the 15 largest investments in both armed conflicts, investors which had a ‘near home bias’ clearly outperformed investors who ‘followed the flag’ as the largest investments in Afghanistan came from countries which had a geographic connection to the host destination. Out of the 15 largest investments, 9 came from this group, with 1 investment coming from the ‘following the flag’ group and 9 investments coming from the ‘other’ group. The ‘near home bias’ also dominated investments in Iraq as 8 of its 15 investments came from this group, with ‘following the flag’ doing better with 6 large investments and 1 coming from ‘other’.

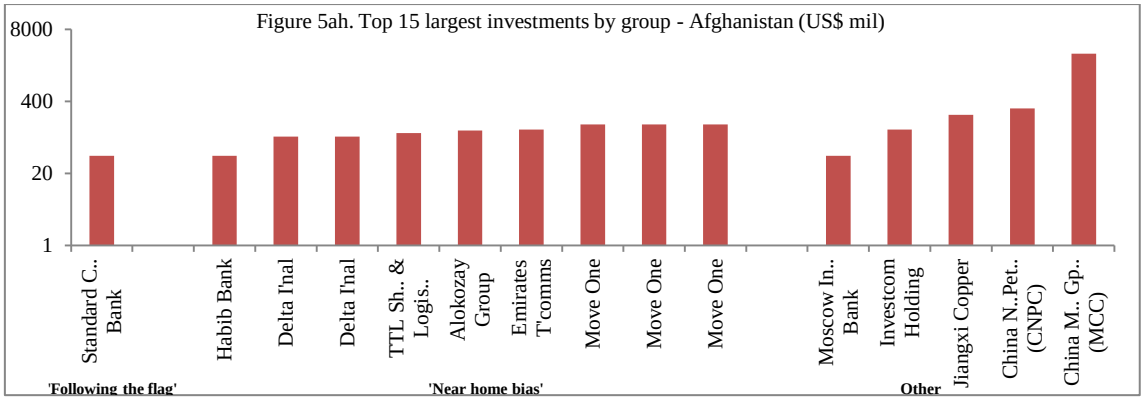


Figure 5ah. Top 15 largest investments by group - Afghanistan (US$ mil)

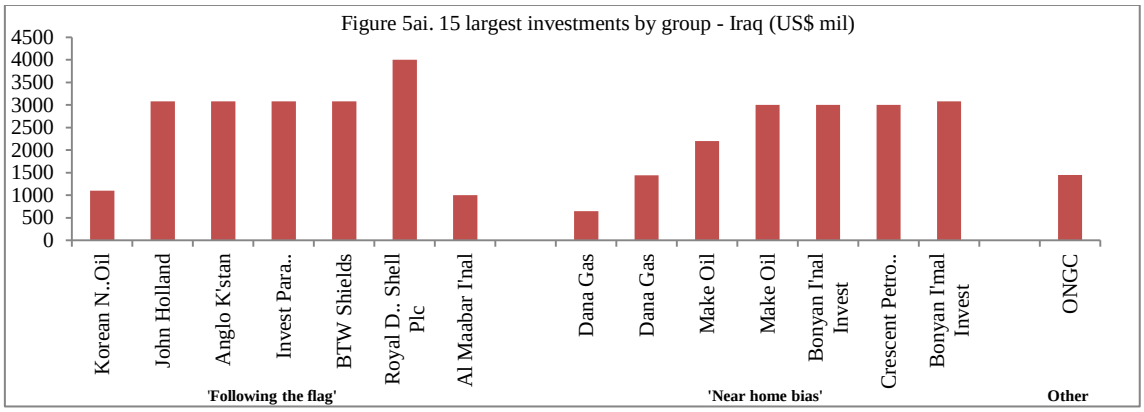


Figure 5ai. 15 largest investments by group - Iraq (US$ mil)

Data in logarithmic scale (20) (*source: FDI Markets*)

From the large investments that were carried out, it was noticeable that in Afghanistan, 6 out of its 15 largest investments came from the UAE, with 3 coming from China and 2 coming from Kyrgyzstan. In Iraq, the UAE also made 6 of the largest investments, with 3 coming from the UK and 2 from Lebanon. The large investments in Afghanistan were spread across 7 sectors with the transportation sector attracting 4 investments, financial services attracting 3 investments, and the remaining investments made in the building, construction and materials, real estate, communications, metal extraction and coal, oil and natural gas sectors. In Iraq, large investments were not as diversely distributed over a large number of sectors as its large investments were confined to only two sectors. These included 8 investments in real estate and 7 investments into its coal, oil and natural gas sector.

5.8 Triangulation of data – MNCs attitudes towards armed conflict

Up until now the data indicates that foreign investors are still attracted to conflict zones as investment destinations, with market opportunities likely to emerge through armed conflict. The data also pointed towards rates of FDI flows likely to be higher during an armed conflict with the likely influential variable being an external military intervention. Chapter 4 and 5 used hard FDI data, with chapter 4 concentrating on aggregated cross-national FDI flows, whilst chapter 5 concentrated on disaggregating FDI data in the case studies of Afghanistan and Iraq. Although the two approaches helped understand the armed conflict-FDI relationship, the approach was based on the reading of broad data and descriptive statistic without linking the results to attitude surveys on multinational corporations (MNCs) which could shed further light on how they perceive armed conflict.

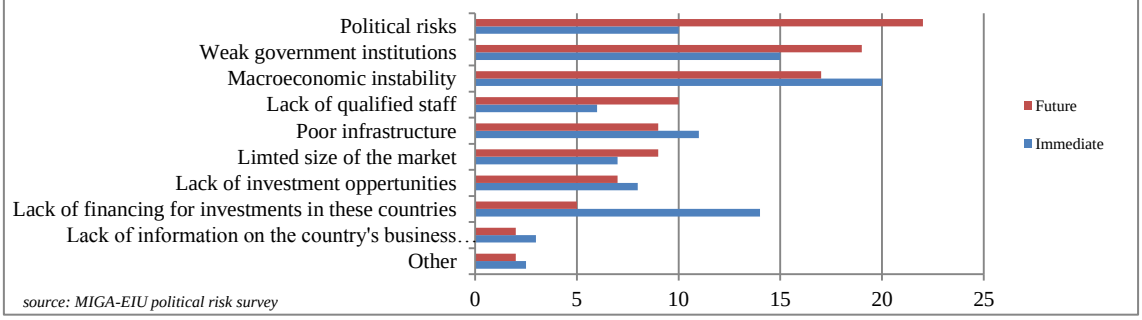
This section uses a survey on MNCs attitudes towards armed conflict in order to triangulate the data presented in this thesis, and offers further evidence in support of the argument that armed conflict does not have the same effect on FDI as discussed in the literature with foreign investors not uniformly risk-adverse. The survey evidence also shows that although foreign investors are concerned with the risks associated with armed conflict, other factors are considered to be more relevant when making investment decisions; whilst the onset of an armed conflict does not necessarily lead to existing foreign investors from changing their investment strategy, nor withdrawing an existing investment or cancelling a planned investment.

5.8.1 Ranking of the most important constraints to FDI

The Multilateral Investment Guarantee Agency (MIGA) of the World Bank surveyed a large number of MNCs from a broad range of industries which operated in fragile and

conflict affected countries of the developing world. The survey aimed to assess how foreign investors perceived the threats emanating from political risk and armed conflict and assessed the factors which often contribute towards the decision making process of MNCs when selecting a fragile or conflict affected country as an investment destination. The survey began by asking MNCs to weigh the most important short and medium term (12 months to 3 years) constraints to their investments and operations and found that political risk which includes security and policy related threats was the single most important constraint for foreign investment in the medium term.[91] This was cited over other factors including macroeconomic instability, limited financing, poor infrastructure and small market size (see figure 5aj). Factors which had a direct bearing to political risk also weighed heavily as an investment constraint with weak government institutions including corruption ranked second. In the short term, MNCs cited recession-like conditions as being an obstacle to cross-border investment plans with macroeconomic instability and lack of financing at the forefront of investors' concerns, however, over the medium term these concerns became relatively less prominent, perhaps suggesting that MNCs expected economic constraints to ease off with an economic recovery, but not expecting political risk to stabilise.[92]

Figure 5aj. Ranking of the most imporant constraints for MNCs (% of respondents)



source: MIGA-EIU political risk survey

[91] Security related threats include armed conflict, civil unrest and terrorism whilst policy related threats include breach of contracts, expropriation, and transfer and convertibility restrictions etc.

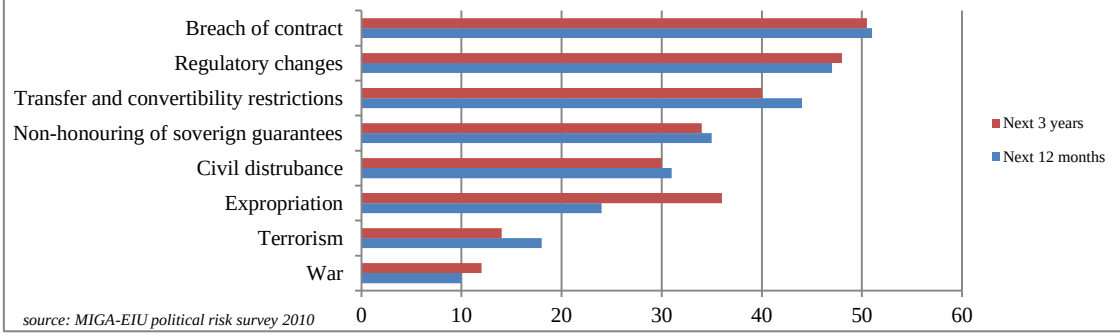
[92] It must be acknowledged that the survey was conducted in 2010 when economic constraints due to the global recession hindered global FDI flows; however, the survey aims were to access the broad range of political risks affecting FDI.

5.8.2 Types of political risks of most concern to MNCs

Political risk contains a broad selection of political threats including armed conflict, civil disturbance and terrorism (security related) to changes in government regulation or expropriation (policy related). Each threat affects the operations of MNCs differently with security related threats leading to asset destruction and disruption to domestic markets whilst policy related threats leading to expropriation of the investment without compensation, or transfer and convertibility restrictions. Security related threats are seen as the single most challenging obstacle to cross-border investments and for MNCs which are already operating in fragile and conflict affected countries security threats have a far detrimental impact on their investments as it disrupts and destroys their operations whilst leaving a lasting detrimental effect on economic, political and social infrastructure (see Berman 2000). The survey suggests that although MNCs viewed security related threats as an obstacle to cross-bored investments, policy related threats which lead to adverse government interventions such as expropriation, restrictions on currency transfer and convertibility, regulatory changes and non-honouring of sovereign guarantees were considered as a greater constraint to their investments (see figure 5ak). Possible reasons why MNCs ranked policy related threats over security related threats could be because: i) of past events where MNCs incurred losses through adverse government intervention; ii) MNCs felt confident that there was relative stability in the fragile and conflict affected country for political violence not to be of concern for both the short and medium term; iii) MNCs were able to manage conflict affected risks through moving operations to a neighbouring country, substituting supply chains or had greater information asymmetry thereby able to identify conflict dynamics and protect against possible losses; and iv) MNCs exposure to armed conflict was limited as there

was sufficient security and/or, the conflict was isolated to non-commercial areas of the country which allowed for investment to be made.

Figure 5ak. Types of political risk of most concern to MNCs (% of respondents)

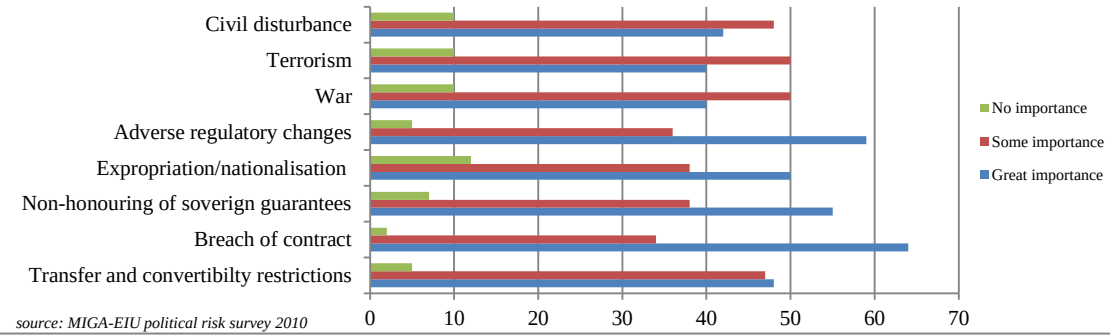


source: MIGA-EIU political risk survey 2010

5.8.3 Most important risks to MNCs when deciding on the location of FDI

In the earlier chapter it was suggested that the relationship between political risk and FDI is not straight forward as different types of political risk have different bearings on the decision making process and operations of MNCs. Armed conflict is seen as a key determining factor in the decision making process of MNCs when making decisions on cross-border investments as they face increased premiums due to armed conflict having the potential to disrupt and destroy assets, markets, and supply chains. The results from this thesis have so far shown that foreign investment continues to flow into countries which are affected by armed conflict with conflict dynamics (intensity and spatial patterns) unable to explain the distribution of FDI.

Figure 5al. Most important risks to MNCs when deciding on the location of FDI (% of respondents)

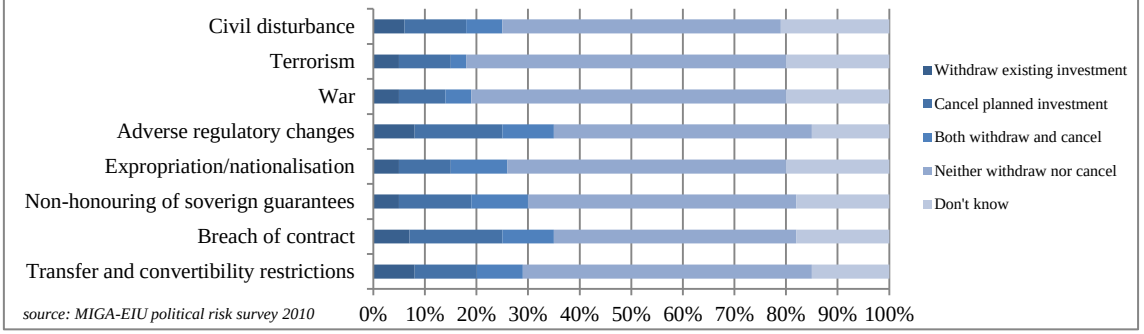


source: MIGA-EIU political risk survey 2010

The survey evidence [to some extent], collaborate with the findings of this thesis as MNCs which are looking to invest in fragile and conflict affected countries put more weight on government policy as a constraint to their investment. Here the evidence suggests that losses occurred through adverse regulatory changes, expropriation, non-honouring of sovereign guarantees, breach of contract, and transfer and convertibility restrictions were considered as the most important risks to MNCs when deciding on the location of their FDI. These risks weighed more heavily compared to security related threats such as civil disturbance, terrorism and armed conflict, although these risks still had some importance assigned to them.

This finding was also supported by MNCs responses towards risk which would lead to disinvestment or the cancellation of an existing investment (see figure 5al). Within the security studies and international political economy literature, security related risks should lead to disinvestment and the cancellation of future investments, however, the survey evidence pointed towards a majority of foreign investors as not viewing these risk as a reason to cancel a planned investment or withdrawing from an existing one. Political risks that most often caused financial losses and ranked high in investors' concerns – such as armed conflict or terrorism – relative to other perils resulted in only a minority of MNCs reconsidering their investment plans. The risks which again weighed heavily in risk assessment were policy related with the majority of cancellations and withdrawals of FDI based on regulatory changes which could lead to expropriation and a breach of contract. This coincided with the findings of this thesis which showed that conflict onset did not lead to disinvestment, whilst FDI flows were unaffected in most cases within the conflict sample.

Figure 5am. Risks causing MNCs to disinvest or cancel an existing investment (% of respondents)



source: MIGA-EIU political risk survey 2010

Amongst the reasons cited in section 5.8.2, another reason which could explain why security related threats featured so low amongst the other political risk and why armed violence did not appear have a bearing on the withdrawal and cancellation of an investment could be surmised on the rise of investment expropriation over the past few years. Investment expropriation has seen MNCs operating in the extractive and primary sectors from suffering significant losses through changes in host government policy (see Lee et al. 2012 and Morris 2014). Therefore, it was not surprising to see from the survey that MNCs viewed the risk of outright expropriation to be of greater concern than the risks emanating from armed violence. MNCs which operate in resource extraction, but also in construction, manufacturing, telecommunications and utilities often rely on host government licences and contracts and are therefore worried by adverse regulatory changes which could lead to expropriation, breach of contract and asset stripping.[93]

5.8.4 Proportion of MNCs that identify political risk as the top constraint to FDI

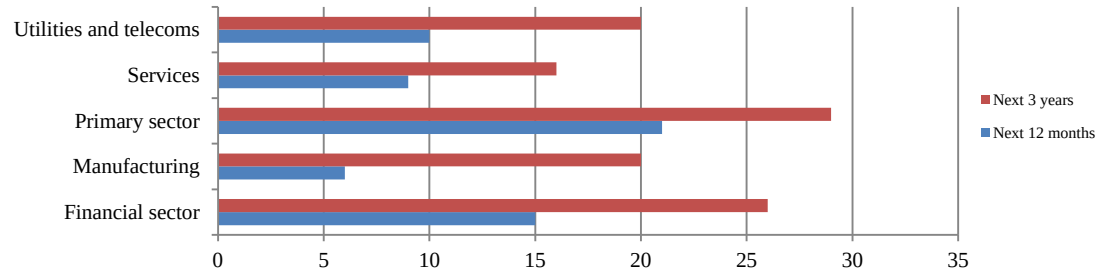
Earlier in the thesis (see chapter 2) it was discussed that the threats MNCs face when operating in conflict zones can be predicted depending on the sector they operate in with the capital intensive sectors at most risk from armed conflict (see Berman 2000).

[93] According to a Chatham House report (see Lee et al. 2012) conflict over ownership of mining and energy resources as well as other primary industries is a growing concern for foreign investors. In 2012, outright expropriation for the extractive resource industries alone accounted for $13 billion in losses for foreign investors. This included Repsol's controlling stake in YPF in Argentina, and the asset stripping of Rio Tinto in Guinea and First Quantum Minerals in the Democratic Republic of Congo (see Morris 2014).

Despite this, disaggregated FDI data in the empirical body of this chapter identified trends which suggested that in Afghanistan and Iraq a counter intuitive relationship existed where the primary sectors along with construction, manufacturing, telecommunications and utilities were the biggest beneficiaries of FDI. This indicated that these capital intensive sectors were [to some extent] resilient towards conflict affected risk as MNCs took advantage of the market opportunities that were created as a consequence of the armed conflicts.

The survey evidence shows that MNCs operating in the primary and financial, manufacturing, services, telecommunication and utilities sectors considered political risks as a constraint to their investments both in the short and medium term, although there were significant differences in perceptions across the sectors (see figure 5an). The proportion of MNCs in the primary sector that found political risk to be the main investment constraint was larger than in any other sector, both in the short and medium term. This finding is likely a reflection that investors in that sectors – mostly the extractive industries – often operate in difficult and risky environments, with significant sunk costs and long-time horizons. And as they are bound by the geography of mineral deposits, they are more constrained in selecting their investment destinations than investors in other sectors.

Figure 5an. Proportion of MNCs that identify political risk as the top constraint of FDI (% of respondents)

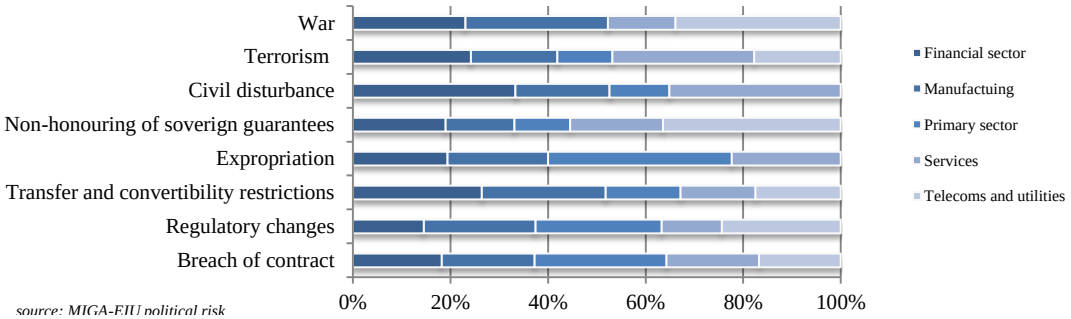


source: MIGA-EIU political risk survey 2010

5.8.5 Political risk perceptions by peril and sector

Further evidence emerged on risk perceptions by sector which suggested that the extractive and primary sectors perceived policy related threats as an investment constraint over security related threats. The primary sectors perceived expropriation as its biggest threat, whilst MNCs operating in telecommunications and utilities were most concerned with adverse regulatory changes. From the survey, a large number of MNCs operating in telecommunications and utilities – which have offtake agreements or guarantees from the host government – were most concerned about the willingness and ability of authorities to fulfil their financial obligations. MNCs which operated in the financial services saw currency transfer and restrictions as the major constraint to their operations due to their reliance on cross-border operations for financing. Moreover, political violence which includes armed conflict, civil disturbance or terrorism ranked lowest across the sectors compared to other forms of political risks (see figure 5an).

Figure 5ao. Political risks perception by peril and sector



There were no insights given as to why policy related threats were considered as a major constraint to cross-border investment over security related threats across the sectors, however, a possible reason lays in Berman's (2000) assertion that MNCs operating in resource extraction are better able to safeguard their operations as mining and extraction of minerals, metals, gas and oil are isolated and geographically confined to a few select places which makes them easier to protect. Furthermore, due to the

nature of their products, possible losses incurred through domestic demand shocks are reduced as MNCs are able to shift their markets from the domestic to the international. However, this reasoning cannot be applied to the non-extractive capital intensive industries such as financial, telecommunications and utilities as their need for multiple assets across the country make it difficult to safeguard against asset destruction whilst their dependence on domestic markets makes them vulnerable to domestic demand shocks. Although this reason is intuitive, the findings from the case study analysis indicated a counter intuitive trend where the non-extractive and capital intensive sectors were fiercely contested by MNCs seeking licences and government contracts.

5.8.6 Perception of political risk by geography

Earlier, this chapter established that there was a relationship between the near home bias where MNCs operating in Afghanistan and Iraq took advantage of their geographic proximity to both armed conflicts and made sizeable investments despite the heightened risks. This suggested that the perception of armed conflict as a deterrent to FDI was based broadly [to some extent] on regional and cultural characteristics as well as information flows shared between the MNCs and the investment location as this acted as a mitigating factor which enabled investments to be made. MNCs which came from outside the region and did not share any cultural or social characteristics had a greater expectation of armed conflict as an investment constraint with information asymmetry problems amongst contributing factors which acted as a deterrent to cross-border investment projects. The MIGA survey, however, offered no significant evidence to suggest that risk perceptions between MNCs varied on regional factors and thus suggested that investors' expectations of political risk as a long term constraint was consistent across the board. Although the MIGA survey didn't disaggregate its respondents in terms of region or whether the MNCs and the host shared a common

border, it did separate MNCs from developed and developing countries and northern and southern hemisphere with the rational being that MNCs from the southern hemisphere were more tolerant towards political risk because of their familiarity in operating in politically risky domestic environments (see MIGA 2010). The survey showed that regional variations did not alter MNCs perceptions of political risk with north and south-based investors concerned with adverse regulatory changes such as transfer and convertibility restrictions and breach of contract with no real evidence to support the notion that the familiarity of south-based MNCs operating in risky domestic environments changed their perception of political violence, however, there was some indication that political violence weighed more heavily with MNCs operating from the northern hemisphere compared to the south.

5.9 Conclusion

The broad study in chapter 4 raised some interesting and unexpected findings which this chapter has explained through a case study approach. These case studies have identified some interesting patterns in relationship to the research question: *Why do countries involved in armed conflict continue to attract FDI?* This includes finding further evidence to support the argument that armed conflict does not discourage all foreign investors and that the rates of FDI tend to be higher during an armed conflict if there is an external military intervention. In doing so, this chapter also presented empirical evidence to show that foreign investors located their investments in areas which had a high concentration of armed violence; that FDI in armed conflicts was not dependent on its size or the sector, and that 'following the flag' and 'near home bias' accounted for the greater share of FDI in armed conflicts. These findings [to some extent] were supported by the survey evidence of MNCs operating in fragile and conflict affected countries which showed that although political violence was considered as a constraint

to cross-border investments, policy related threats weighed more heavily in the decision making process of MNCs compared to security related threats. In disaggregating the sample of MNCs, the survey showed that the perception of political risk as an investment constraint was consisted across the different sectors; whilst security related threats – although an obstacle to foreign investment – was not considered a greater hindrance to FDI compared to policy related threats. This was supported by evidence showing that political violence was ranked lower than policy related threats as factors which could cause MNCs to cancel a planned investment or withdrawn from an existing project. The survey, however, was unable to offer any evidence in support of the near home bias as MNCs responses did not support the notion that south-based MNCs were more tolerant towards political violence because of their familiarity in operating in risky domestic environments.

The empirical data showed that 40 of Afghanistan's 41 investments and 143 of Iraq's 159 investments were located in provinces which had a high concentration of armed violence. In total FDI, this amounted to $4,733.4 billion of Afghanistan's total FDI of $5033.4 billion and $45,997 billion of Iraq's total FDI of $59,724.89 billion, which suggested that Berman's (2000) assertion that foreign investors avoid areas which have a high concentration of armed violence did not apply. This was further supported by the results of the survey which suggested that armed conflict was not high on a list of factors which determine the selection of an investment location.

To add to the above argument, the disaggregate FDI data also showed that provinces which had the highest concentration of armed violence were also the most popular destinations for foreign investment. For instance, in Afghanistan and Iraq, the largest share of its FDI was located in its most violent provinces with the capital cities of Kabul and Baghdad the destination for the largest volume of FDI and the largest number of

investments. The data also showed that Future FDI was unaffected by armed conflict as foreign investment rates were higher following periods of intense violence. Taking into consideration the time-lag, data from Afghanistan and Iraq showed that intense periods of armed violence did not discourage future FDI flows as foreign investors were not discouraged by conflict intensity.

The size of foreign investments also appeared to have no particular relationship to armed conflict, although, intuitively, larger investment carried greater risks. The data showed that Afghanistan and Iraq not only continued to attract FDI, but also managed to attract investments of various sizes with the majority of their investments in the large investment range. This suggested that armed conflict did not discourage foreign investors from making large investments. Breaking down the value of the investments by year provided no evidence to suggest that a particular trend was evident. It was expected that the uncertainty surrounding the onset of armed conflict would discourage large investments but FDI trends in both armed conflicts failed to provide any evidence that this was the case. This also applied to the intensity of armed violence by province which showed that increases in conflict intensity had no negative effect on the size of the investments.

FDI by sector did provide some organised trends; however, this differed between the case studies. The first trend was expected as the majority of Afghanistan's FDI was located in its natural resource sector (68%) but this did not apply in Iraq as its natural resource sector only attracted 36% of its total FDI. The second trend showed that capital intensive sectors attracted the largest volume of investments with the natural resources, real estate and telecommunications sector the most attractive sectors for investment; however, the least capital intensive sectors attracted the largest number of investments, with business and financial services attracting more investments than any other sector.

These results fitted in with the survey evidence which showed that MNCs were concerned with both security related and policy related risks, although armed conflict was not amongst the most concerning factors for FDI choices.

The origin of FDI revealed that the investment climate was dominated by investors who 'followed the flag' and investors who took advantage of the 'near home bias'. Although in Afghanistan these two groups represented a smaller proportion of total FDI, investors from these two groups made the most investments with 34 of Afghanistan's 41 investments coming from investors 'following the flag'. And in Iraq, these two groups dominated the investment climate by making the largest volume of investments and making the largest number of investments. The 'near home bias' dominated the volume of FDI as 57.3% of its total FDI came from neighbouring/regional countries, whilst both groups made the largest number of investments as 74.22% of all investments came from either investors 'following the flag' or taking advantage of the 'near home bias'.

As well as making the largest number of investments and dominating the investment climate by volume, the 'following the flag' and 'near home bias' were also responsible for making the largest investments. In Iraq, the top 5 largest investments came from these two groups whilst in Afghanistan 2 of the top largest investments came from these groups. Additionally, the top 15 investments in both armed conflicts came from either 'following the flag' or the 'near home bias'. Although the data suggested a relationship between FDI to 'following the flag' and the 'near home bias', survey evidence from MNCs could not support this trend as no evidence was found that familiarity in operating in domestic risky environments resulted in MNCs tolerating political violence in cross-border investments.

And finally, no evidence was found to suggest that military contributions correlated with investment volumes, which suggested the possibility of 'free riding'. The UK and the US were the two largest military contributors to the EMI in Afghanistan and Iraq, and yet their FDI was below the FDI of countries which contributed fewer or no troops. This included countries such as the UAE which dominated the investment climate in both armed conflicts but contributed very little to the EMI, as its contribution extended to only 35 combat troops in Afghanistan and no troops in Iraq. This suggested the presence of 'free riding as countries which offered little or no contribution to the EMI took advantage of the market opportunities that were created because of the military intervention in Afghanistan and Iraq.

The method used in this chapter offered an abundance of data to support the hypothesis that FDI continues to flow into armed conflict with rates of FDI likely to be higher if there is an external military intervention. In doing so, this chapter presented disaggregated FDI and armed conflict data in order to provide a micro-analysis of the variables, but also to address some of the limitations which arose from chapter 4. In addition, the method brought into consideration attitude survey of MNCs who have operations in fragile and conflict affected countries to assess their perceptions of political risk. The survey evidence was able to triangulate the quantitative evidence and offer some support to the findings which revealed that political violence is not a major constraint to cross-border investments with adverse policy changes which result in the breach of contracts and expropriation ranked higher. However, the survey was limited and could not offer any evidence to support the main argument of this thesis that foreign investors are more likely to invest in conflict zones providing that foreign countries intervene with 'boots on the ground'.

CONCLUSION

Why do foreign investors put funds at risk by investing in conflict zones? This remains a central question for debates on the economic effects of armed conflict within two leading schools of thought. These schools offer contrasting perspectives on whether armed conflict is good *or* bad for business, with the first perspective from the 'war ruin' school arguing that armed conflict is bad for business as it produces a series of severe negative economic consequences. The second perspective from the 'war renewal' school argues that armed conflict can have a positive impact on the economic, political and social landscape of a country because it can serve to reduce rent-seeking and to remove the patronage networks of elite groups, who inhibit economic and social development in favour of preserving their interests. Although the 'war ruin' school dominates the literature on the economic effects of armed conflict, recent examples have emerged which offer empirical evidence in support of the 'war renewal' school – this evidence generated the research puzzle which was explored in this thesis.

The existing literature in both security studies and international political economy scholarship suggests that foreign investors are prone to being risk-adverse when faced with political instability and armed conflict (see Woodward and Rolfe 1993, Schneider and Rey 1985, and Li 2006), and as such are unwilling to accept the higher risk premium associated with investments in conflict zones (see Asiedu 2002, and Pierpont and Kreuger 2005). This thesis has challenged this conventional wisdom, and has demonstrated that – under specific conditions – foreign investment continues to flow during armed conflict, while the onset of armed conflict in some cases leads to increased rates of FDI.

The primary objective of the thesis has been to contribute to our understanding of the paradoxical nature of the armed conflict-FDI relationship. In doing so, the thesis has illustrated how, and under what conditions, not all foreign investors are risk-adverse when it comes to investing in conflict zones. Specifically, the thesis has suggested that the presence of an external military intervention (EMI) involving ground troops can lead to increased rates of FDI. The research presented in the thesis therefore holds counterintuitive insights for existing theoretical debates about the social and economic impact of armed conflict, and offers support for the claims made by the 'war renewal' school that armed conflict can, in specific circumstances, be good for business.

Summary of empirical findings – Part one: quantitative analysis

This thesis has used a multi-method approach in order to analyse both cross-national conflict and investment trends, and to disaggregate the specific conditions that shape the dynamic relationship between armed conflict and foreign investment in individual cases. This was based on a large-*N* study using descriptive statistics on internal armed conflicts (1996-2010), a structured focused comparison of the internal armed conflicts in Afghanistan (2003-2012) and Iraq (2003-2010) and a survey on MNCs attitudes towards armed conflict in order to address the question: *Why do countries involved in internal armed conflict continue to attract FDI?* Chapter 4 examined four primary lines of enquiry, the findings from which are briefly summarized below.

The four lines of inquiry in chapter 4 included an analysis of general FDI trends of internal armed conflicts, and found that cross-national trends suggest that foreign investment not only increases during armed conflict, but, in some cases, FDI levels are higher during an armed conflict compared with pre-conflict and post-conflict FDI. These arguments were supported by the empirical analysis which showed armed

conflict does not have a consistent negative effect on FDI. Beginning with the most developed countries in the sample which included Israel (developed countries - Asia), Russia (transition economies) and Turkey (high-income developing countries (HIDC)), FDI either remained at pre-conflict levels or increased to outperform the average FDI trend for each economic category of countries. Although FDI levels were unaffected by the loss of political stability, the absence of a negative relationship was not surprising as both the conventional wisdom in the existing literature as well as historical trends in FDI data indicate a positive correlation between the level of a country's economic development and FDI. Therefore, it was expected that the negative effects of armed conflict would be less pronounced in the more developed group of countries.

It was in the less developing group of countries where counterintuitive trends in the armed conflict-FDI relationship emerged more strongly. These trends not only offered empirical evidence to suggest that armed conflict has a positive effect on FDI, but also offered analytical insights in support of the 'war renewal' school that armed conflict can be good for business. Beginning with middle-income developing countries (MIDC), the data showed that armed conflict facilitated a higher rate of FDI, which was above pre-conflict and post-conflict FDI. This included armed conflicts in Algeria, Colombia, Philippines, Sri Lanka and Thailand where FDI was unaffected by armed conflict, and Peru where the rate of FDI was significantly higher during its armed conflict compared to its pre-conflict and post-conflict FDI.

In contrast, some evidence showed that armed conflict does have a negative effect on FDI which supports the assumptions of the 'war ruin' school. Nevertheless, this effect was short lived as long term foreign investment (during armed conflict) reaffirmed the paradoxical relationship between armed conflict and FDI. This was established in Congo, Egypt and Iran where FDI fell during their armed conflicts but soon recovered

once peace had been restored. Although this suggests that armed conflict is bad for business as it can deter new FDI and lead to capital flight, in these cases rates of FDI during the post-conflict period offer further support for the arguments of the 'war renewal' school as foreign investment rose above pre-conflict FDI. This suggested the emergence of the 'phoenix factor' (see Organski and Kugler 1980), where armed conflict accelerates the rate of economic development in the post-conflict period. This indicated that the higher rate of FDI in the post-conflict period was the result of armed conflict, which was supported by the lower rates of FDI in the period immediately before the start of an armed conflict.[94]

Although it was expected that the negative effects of armed conflict are stronger in low-income developing countries (LIDC) – as these countries tend to struggle to attract FDI during peacetime – the data analysed in chapter 4 suggests three counterintuitive trends. First, the data suggests that the negative effect of armed conflict on FDI is short-lived as FDI recovers with rates exceeding pre-conflict FDI. This was evident in Afghanistan, Chad and Sudan. Second, armed conflict can lead to FDI levels exceeding pre-conflict FDI, which falls once peace had been restored. This was evident in Angola and Iraq. Finally, armed conflict in some cases has had no effect on FDI, with Cambodia, Ethiopia and India maintaining their pre-conflict FDI levels.

These results are significant because they suggest that foreign investment sometimes increases during armed conflict. This goes against the conventional wisdom in the existing literature, whereby armed conflict is expected to increase the commercial and non-commercial risks of doing business, with foreign investors unwilling to pay the higher risk premium associated with investments in armed conflicts.

[94] It must be acknowledged that the standard explanation would suggests that the destruction of resources/property (especially if armed conflict generates a prolonged period of belt-tightening and austerity) automatically creates greater demand for higher post-conflict investment during the period of 'reconstruction'.

Chapter 4 also examined whether conflict intensity is a determinant of FDI, as the existing literature suggests that high-intensity armed conflicts are most likely to have a consistent effect in deterring foreign investment (see Berman 2000). In contrast to this assumption, the data indicated that the level of conflict intensity had no negative effect in more developed countries, while some negative isolated effects were identified in less developed countries. Although it was noticeable that the negative effects of high-intensity armed conflict correlated with a low level of economic development, the majority of the cases indicated that high-intensity armed conflict had a reverse effect as it led to increased FDI.

The following three trends were identified with respect to the impact of conflict intensity on rates of FDI in the low-income developing countries group (LIDC). First, high-intensity armed conflicts in Chad, Democratic Republic of Congo, India, Nepal and Sierra Leone led to a decrease in investment levels with FDI falling below the level of FDI during low-intensity armed conflict and pre-conflict FDI. Second, high-intensity armed conflicts in Angola, Iraq, Sudan and Rwanda were associated with an increase in investment levels with FDI increasing above pre-conflict FDI. Third, high-intensity armed conflict had no distinguishable effect on investment levels in Afghanistan and Uganda, where the rate of FDI was unaffected by armed conflict. While the first trend was an expected finding that corresponded with the existing literature, the second and third trends represented more counterintuitive findings that demonstrated that the relationship between armed conflict and foreign investment was more complex than is commonly assumed. In particular, these trends suggested that the level of conflict intensity as a determinant of foreign investment was not able to provide a convincing explanation for the distribution of FDI in armed conflicts.

The analysis in chapter 4 also examined the role of external military intervention (EMI) as an independent variable on rates of FDI. This variable was brought into the investigation to establish whether EMI which includes 'boots' on the ground' potentially sends a positive signal to foreign investors. The data indicated that EMI often leads to positive and increased FDI in armed conflicts, with foreign investment higher under an EMI compared to pre-conflict FDI. In addition, the data analysis demonstrated that average FDI for armed conflicts under an EMI was higher in comparison with armed conflict without an EMI. This suggests that increased FDI in armed conflict is causally linked to the presence of independent states intervening with 'boots on the ground'.

Finally, chapter 4 also analysed the impact of EMI on conflict intensity and how this affected FDI. A standard explanation for the capacity of EMI to increase FDI is that the 'positive signal' it potentially sends to foreign investors is dependent on whether an EMI is able to reduce conflict intensity or to bring conflict to an end. In contrast, the data analysis suggests that while the rate of FDI is significantly influenced by an EMI, this is not dependent on an EMI leading to a reduction in conflict intensity. This was supported by evidence that the withdrawal of 'boots on the ground' led to reductions in FDI.

Summary of empirical findings – Part two: qualitative analysis

The conclusions drawn from chapter 4 were based on analysing aggregate data on armed conflict and FDI, which produced counterintuitive findings that required a more in-depth analysis of FDI dynamics in specific cases of armed conflict. Using a structured focused comparison of the internal armed conflicts in Afghanistan (2003-2012) and Iraq (2003-2010), chapter 5 disaggregated armed conflict and FDI data in

order to further unpack the research findings generated in chapter 4. These were explored through three primary lines of inquiry, the findings of which are briefly summarised below.

The three lines of inquiry in chapter 5 included an analysis of how the spatial dynamics of armed conflict affects FDI, as the literature suggests that widespread armed conflict has a more detrimental effect on foreign investment than localized armed conflict, which investors can potentially avoid. The data analysis showed that the cross-national spread of armed violence had no negative effect on FDI as foreign investments were located in areas which had a high concentration of armed violence. These arguments were supported by the empirical analysis from both case studies which showed that high coalition fatalities in commercial and investment intensive areas did not lead foreign investors to relocate their investments to safer areas, nor did it have a negative effect on rates of long-term FDI. Indeed, the analysis suggested that there was a positive correlation between high casualty rates and the volume of FDI and the number of investments in both cases.

Chapter 5 also analysed whether the size and sector distribution of investment is a determinant of FDI, as the existing literature suggests that small investments are frequent in armed conflicts, whilst capital intensive sectors carry greater potential losses if the investment is exposed to conflict affected risks. The data indicated that the size of the investment appeared to have no particular relationship to armed conflict, although, intuitively, larger investments carried greater risks. The data showed that Afghanistan and Iraq not only continued to attract FDI, but also managed to attract various sizes of investments with the majority in the large investment range. Breaking the investment down by year also offered no evidence to suggest that a particular trend was evident. Rather than the increase in economic uncertainty produced by the onset of armed

conflict discouraging large investments, FDI trends in both armed conflicts failed to provide any evidence that this was the case. This also applied to the intensity of armed violence by province, which showed that increases in conflict intensity had no negative effect on the size of the investments.

The analysis of rates of FDI by sector did reveal some organised trends; however, this differed between the case studies. The first trend was intuitive as the majority of Afghanistan's FDI was located in its natural resource sector (68%), but this did not apply in Iraq as its natural resource sector attracted a smaller share of its total FDI (36%). The second trend was counterintuitive as capital intensive sectors were the largest recipients of FDI, despite the greater potential losses these sectors presented to investors. This included investments in natural resource, real estate and telecommunication sectors. The final trend included the least capital intensive sectors, which had the greatest concentration of investments. These sectors attracted most investments with the business and financial services attracting the greatest number of investments.

Chapter 5 also analysed whether the geographic origin of investment can explain the distribution of FDI in armed conflicts through either investors 'following the flag' or investment patterns being shaped by 'near home bias'. The analysis of the origin of FDI revealed that both factors were influential in attracting FDI into armed conflicts as investment from both groups represented the largest number of investments, although in total FDI the 'near home bias' accounted for the largest volume of FDI. In addition, the largest investments were also made by these two groups, with the 15 largest investments in both armed conflicts coming from foreign investors either 'following the flag' or taking advantage of the 'near home bias'. Surprisingly, no evidence was found to suggest that military contributions correlated with investment volumes, as the largest

contributors of ‘boots on the ground’ did not dominate the investment climate in either case. This suggests the possibility of ‘free riding’, as the biggest beneficiaries of the market opportunities generated from both armed conflicts were countries which contributed either an insignificant number of ‘boots on the ground’ or none at all. This included the UAE, which dominated the investment climate in Afghanistan and Iraq yet contributed only 35 combat troops in Afghanistan and had no troops in Iraq.

And finally, chapter 5 also presented evidence from a survey attitude of multinational corporations (MNCs) towards armed conflict in order to triangulate the data presented in chapter 4 and 5. The results from the survey offered further empirical evidence to show that the threats from armed conflict are not universally shared by all MNCs and does not lead to disinvestment or the cancellation of further investments. The survey also showed that armed conflict was not the greatest concern when making decisions on FDI and had a less than expected influence on the decision making process of MNCs when selecting locations for future investments. Although the survey was able to strengthen the conclusions drawn in this thesis, it was unable to offer any reasons why foreign investors continue to select armed conflicts and whether an external military intervention can facilitate FDI flows into armed conflict. This void in the survey has opened up future avenues of research.

Broader lessons on the armed conflict-FDI relationship

As the forgoing chapters have shown, the relationship between armed conflict and FDI cannot simply be categorized as either *positive* or *negative* across-the-board, but is instead complicated by a series of dynamics that shape how foreign investors assess the greater risk premiums associated with investing in conflict zones. These dynamics play an important role in the armed conflict-FDI relationship, as they can mitigate some of

the potential risks generated by the loss of political stability. External military intervention (EMI) constitutes a key driver of this relationship, which this thesis has argued leads to increased FDI through the 'positive signal' it sends to foreign investors. The influence of external military intervention on investment dynamics in conflict zones is produced through the establishment of a greater level of authority and stability in an incendiary economic and political environment. Moreover, EMI can also improve the investment climate through (at least partially) restoring the rule of law, assisting in the reconstruction of economic and political institutions, reducing the level of violence and working towards a lasting end to the armed conflict.

This study of the armed conflict-FDI relationship provides two broader lessons from the thesis. The first is that although the empirical findings of the thesis suggest that foreign investors are not uniformly risk-adverse, and that external military intervention can mitigate some of the commercial and non-commercial risks emanating from armed conflict, the negative effects of conflict on FDI cannot be discounted. The findings do not support a simple inversion of the core assumption in the existing literature, to suggest that armed conflict is *always good for business*. Armed conflict is destructive in nature and causes asset destruction and theft, as well leading to potential losses incurred through market failure. Therefore, it cannot be assumed that external factors which might improve the investment climate always mitigate the greater risk premium assigned to conflict zones because foreign investors are heterogeneous, and may assess the risks to investment from armed conflict differently in other cases or under different conditions.

The second broader lesson this thesis suggests is that researchers in security studies and international political economy who focus on the negative economic effects of armed conflict need to focus more on the disaggregation of FDI and armed conflict data in

order to gain a better understanding on whether armed conflict is good *or* bad for business, under what conditions, and why. As this thesis has established, the use of general FDI and armed conflict data does not provide for a sufficiently in-depth analysis of the interaction between the two variables as conflict and FDI dynamics are not static. As the investigation in chapter 5 has shown, more can be ascertained by focusing on disaggregate armed conflict and FDI data.

Implications for future research

The core argument and findings in this thesis have important implications for future researchers in this field, not least as the thesis research offers further empirical evidence in support of some of the assumptions of the 'war renewal' school of thought that armed conflict can have a positive impact on FDI. Although security studies and international political scholars have focused on the role of FDI in conflict onset, and FDI in post-conflict reconstruction, studies which have focused on the effects of armed conflict on FDI have tended to neglect the positive impact armed conflict can potentially have on investment. This is especially surprising because much of the research on post-conflict reconstruction and stabilisation is heavily in favour of using the private sector as an instrument of post-conflict stability and peace building. The findings of this thesis therefore help to connect the current gap that exists between the two areas of study. In particular, these findings can aid researchers who investigate the potential for using the private sector as a tool for fostering post-conflict stability to understand how armed conflict shapes the economic climate for both domestic and foreign investors.

The thesis therefore makes two primary contributions to the existing literature in this field. First, it offers further empirical evidence for the 'war renewal' school, which assumes that armed conflict has a positive effect on the economic, political and social

landscape of a country. Second, the thesis has helped to establish that even high concentrations of armed violence in commercial and investment intensive areas do not necessarily discourage foreign investment in these areas.

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APPENDICES